The Bulletin

OMFIF

Winter 2021
Vol.12 Ed.1

IN THE LINE OF FIRE

THE THREATS TO CENTRAL BANK INDEPENDENCE

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Cover illustration: Shonagh Rae @shonaghrae

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Dialogue on world finance and economic policy

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

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

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

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The 173-strong OMFIF advisers network, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors: monetary policy; political economy; capital markets; and industry and investment. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership changes annually owing to rotation.

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Credible questions for 2021

This edition of The Bulletin aims squarely at the big issues that will dominate discussions among policy-makers throughout 2021, and probably for some time after that.

Will inflation return? Will digital currencies take root? What impact will the Biden administration have on geopolitics, and especially China's place in the world? Will the dollar continue to decline? Can sustainable finance make the impact it needs to help combat climate change?

Our cover story this quarter (page 10), written by OMFIF's chairman David Marsh, directly addresses a question that matters hugely to many of our members and readers: what is the role of a central bank today?

It's easy to consider issues relating to central bank independence as a recent phenomenon, brought on by Covid-19. But the virus has amplified a concern that has been present since at least the 2008 global financial crisis, as Marsh and the policy-making luminaries he interviews point out.

The Bulletin poll on page 38 confirms that many members of the OMFIF network share the concerns of central bankers that if monetary policy is placed at the service of fiscal policy, then trust in central banks - the very credibility that underpins the financial system - is at risk.

The problem, perhaps, is that central banks are now operating in too many fields. This has limited their room for manoeuvre, and also given their critics more targets to aim at.

The real crunch will come when central banks have to counter inflationary pressures again. According to most experts, including the authors of our Money Matters column (page 34), that moment approaches. Meghnad Desai, chairman of the OMFIF advisory board, disagrees, saying we have entered a new, long-term era of low inflation (page 31).

As always, OMFIF looks forward to promoting discussion, at our meetings and in our publications, at the highest levels of policy-making.

Clive Horwood
Managing Editor
OMFIF

'IF MONETARY POLICY IS PLACED AT THE SERVICE OF FISCAL POLICY, THEN TRUST IN CENTRAL BANKS - THE VERY CREDIBILITY THAT UNDERPINS THE FINANCIAL SYSTEM - IS AT RISK'

»14 October

Africa's financial markets

OMFIF LAUNCHED the fourth annual 'ABSA Africa Financial Markets Index'. It records the openness to foreign investment in countries across the continent. The index is a premier indicator of the attractiveness and flexibility of Africa's capital markets, for use by policy-makers, investors and asset managers around the world.

»20 October

The sustainability agenda for central banks

FOLLOWING the International Monetary Fund-World Bank Group annual meetings, and as sustainability becomes an increasingly important consideration in Covid recovery plans, Norges Bank and Banco de México discussed how to embed climate issues into central bank policies.

»28 October

Overcoming the roadblocks to CBDC

OMFIF MET with central bank representatives to discuss implications of central bank digital currency and potential methods of implementation. The aim of these sessions was to facilitate informal exchanges between central banks on key issues relating to security, financial stability and public acceptance of a CDBC.

» 13 October

Canada and the Americas

OMFIF AND SCOTIABANK'S Global Capital Markets convened a conference on the Canadian and other American economies, and how these relate to developments in Europe and Asia. For sovereign debt issuers and investors, it provided insights on the main policy and investment themes shaping their sectors in 2020-21, including developments in fintech and ESG.

»15 October

Europe's sustainable recovery

ON THE OCCASION of the International Monetary Fund-World Bank Group annual meetings, DZ BANK and OMFIF convened a panel discussion on Europe's recovery plan.

»19 October

Financial regulation in 2020

WITH EVER MORE actors and forces influencing financial activities, policy-makers and market participants must consider a multiplicity of factors in their decision-making. This seminar, convened by OMFIF and Mazars USA, focused on priorities and challenges in financial regulation.

»29 October

Integration, investment and financial market developments

OMFIF launched a new report, 'Central America: Integration, investment and trade opportunities', produced jointly with the Central American Bank for Economic Integration. It explores the competitive advantages of the Central American Integration System bloc for foreign investment as investors begin to consider opportunities after Covid-19.

»19 November

GPP 2020 launch – Funds face a defining moment

OMFIF LAUNCHED the 'Global Public Pensions 2020' report. Public pensions are at the centre of changes in global finance. The ongoing public health crisis and economic uncertainty have magnified the relevance of these issues, inevitably impacting the ability of pension funds to deliver on their obligations. This launch reviewed the issues covered in the report and presented the findings.

OMFIF Global Public Pensions 2020

»25 November

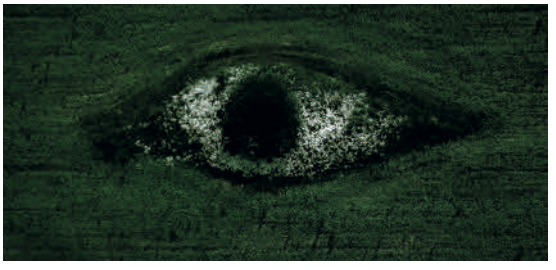
Global economic crisis and gender equality

THE PANDEMIC HAS exposed an array of economic inequalities, with the economic fall-out of Covid-19 disproportionately affecting society's most vulnerable groups. The panel discusses the gendered effects of the crisis, focusing on the economic impact and policy responses.

»18 November

Addressing climate change with capital markets

AN OMFIF panel discussed sustainable bond standards, innovative finance beyond green bonds and how capital can be mobilised for climate change mitigation and adaptation.



»5 November

Monetary and fiscal policy in the face of Covid-19

AS THE Covid-19 pandemic plunges economies all over the world into crisis, governments have had to respond promptly, rolling out large-scale fiscal support. Jens Weidmann, president of the Deutsche Bundesbank, discussed this and other developments in monetary policy.

»14 December

Financial services in the cloud: A summit for regulators

THE AWS INSTITUTE and OMFIF hosted an invitation-only summit for financial services regulators in Asia Pacific. The summit was an opportunity for policy-makers to discuss cloud adoption, best practice approaches to the regulation of financial institutions and their use of cloud and IT, and to hear from cloud and security industry experts. The summit consisted of five 90-minute webinars.

»14 December

Covid-19 recovery, European and German economic outlook

Jakob von Weizsäcker, chief economist at the German federal ministry of finance, gave an overview of the state of the euro area economy. He discussed the shift in geopolitics that Joe Biden's US presidency will bring, as well as relations with Asia and euro area recovery in 2021.

»10 December

The future of payments

OMFIF LAUNCHED 'The future of payments' report and held a panel discussion with DMI members. The panel explored innovations in electronic payments and outlined next steps for national and cross-border governance frameworks. It discussed when and how differing payment innovations are necessary, the role of technologies such as blockchain and the challenges ahead for public-private partnerships.

»9 December

China's global economic vision

JONATHAN HILLMAN and Agatha Kratz of the Reconnecting Asia Project joined Mark Sobel to discuss Hillman's latest book. They also covered Chinese commercial lending, the debt service suspension initiative, sustainability.

»16 December

Analysis of Brexit negotiations

As Brexit negotiations came down to the wire, Ivan Rogers, former permanent representative of the UK to the European Union, shared his thoughts on what was going on behind the scenes. Rogers gave his perspective on the sentiment in Brussels before the two sides finally reached an agreement.

Agenda

»Wednesday 3 February, Virtual

Coming together for sustainability in 2021

An OMFIF-SEACEN roundtable on the actions on the actions needed to support sustainability and impactful change in Asia Pacific in 2021 and beyond. Topics will include the impediments to achieving the United Nations' sustainable development goals by 2030 and the steps needed to overcome these.

»Monday 8 February, Virtual

Euro area stability: view from the IMF

A roundtable with Philip Gerson, deputy director of the International Monetary Fund's European department, about the effects of the pandemic on the euro area economy, setting out key findings from the IMF's December report '2020 consultation on common euro area policies'.

»Thursday 11 February, Virtual

Launch of Diem

A panel discussion with Christian Catalini, chief economist at the Diem Association, on the launch of Diem. Catalini will outline the stablecoin's key features and uses, the regulatory response and associated risks.

»Monday 15 February, Virtual

Monetary policy of central eastern Europe

A panel with deputy governors from the Czech, Hungarian and Polish central banks on how central and eastern European economies fared with the pandemic and their recovery plans.

»Tuesday 23 February, Virtual

Infrastructure in the Covid-19 recovery

A panel with Jin Liquin, president of the Asian Infrastructure Investment Bank, and OMFIF's David Marsh, to discuss the emerging infrastructure trends that are shaping Asia's post-pandemic recovery and priorities for the bank as he celebrates his second term with the institution.

»Wednesday 8 March, Virtual

Gender Balance Index 2021 launch

The launch of the eighth Gender Balance Index. The discussion will focus on how central banks and public investors can plan and contribute to a more inclusive recovery, given the pandemic's disproportionate impact of the pandemic on women and minorities.

For details visit omfif.org/meetings

THE THREATS TO CENTRAL BANK INDEPENDENCE

IN THE LINE OF FIRE

THE ECONOMIC BATTLE AGAINST COVID-19 HAS BLURRED THE BOUNDARIES BETWEEN FISCAL AND MONETARY POLICY. BUT THE THREATS TO CENTRAL BANK INDEPENDENCE RUN DEEPER THAN THE CURRENT CRISIS.

DAVID MARSH
OMFIF

A spectre is haunting the world of finance: central banks that have lost their power to shock. Charles Goodhart, veteran professor at the London School of Economics, a grandee of international money, has been proclaiming that, when inflation starts to rise again, these traditional guardians of rectitude will no longer be able to raise interest rates.

Over the past 30 to 40 years, central banks were granted widespread statutory independence from political influence in a sweeping worldwide shift. But according to Goodhart's thesis, they will be forced to bow to government pressure to keep interest rates low and prevent a ruinous spike in the servicing costs of debts massively boosted by the pandemic.

Faced with a stark choice, governments and (it is claimed) increasingly subservient central banks seem to be opting for inflation over default. After all, higher prices inflate away debt – shown historically by booming economies running out of control after wars and plagues. 'Look back nostalgically at your time of independence,' Goodhart puckishly tells his central banking audiences. 'It was nice while it lasted.'

The debate has heated up. Forecasters point to a rise in US inflation beyond the Federal Reserve's 2% target later this year as the US economy shifts to major post-pandemic expansion after a decade of near-constant undershooting. Treasury Secretary Janet Yellen will not wish overtly to undermine Fed independence, but she will try to swing the Fed behind the administration's pro-growth agenda. Yellen knows her Fed chair successor Jay Powell will not want to upset the government by tightening money when bidding for a second term from February 2022.

There have been frequent squalls over central banks' waning capacity – perceived and real – to

'FISCAL POLICY EMPOWERS MONETARY POLICY BY FOSTERING DEMAND...AND MONETARY POLICY MAKES FISCAL POLICY MORE EFFECTIVE.'

CHRISTINE LAGARDE

'IT IS GOOD TO HAVE IMPLICIT CO-OPERATION BETWEEN MONETARY AND FISCAL POLICY. THIS IS NOT A LOSS OF CENTRAL BANK INDEPENDENCE.'

MARCEL FRATZSCHER

'MY WORRIES ABOUT INDEPENDENCE DO NOT STEM FROM CONCERN ABOUT FISCAL DOMINANCE, MORE BECAUSE OF THE RANGE OF NON-TRADITIONAL FIELDS THAT CENTRAL BANKS NOW SEEK TO ADDRESS, SUCH AS CLIMATE CHANGE MEASURES AND GENDER BALANCE. THEY ARE DABBLING IN ISSUES THAT ARE MORE DIFFICULT TO CONTROL, MEASURE AND COMMUNICATE.'

BARRY EICHENGREEN

stand up to governments. The battlegrounds include emerging market economies like Turkey, Brazil, Nigeria and Malaysia. Also included is the UK, where the Bank of England is widely regarded as carrying out monetary financing of a gigantic Covid-19 budget deficit – a charge it denies.

However, the independence controversy is most virulent in Europe's 19-nation economic and monetary union. After more than 20 years, the EMU still resembles an enormous financial and political experiment.

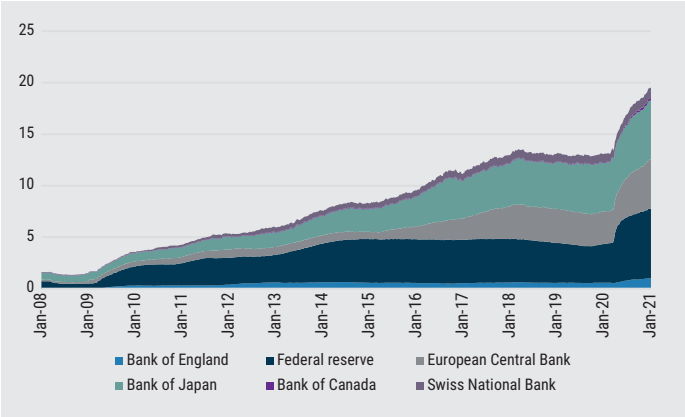
The fulcrum of EMU is Frankfurt, where Germany's Bundesbank was set up after the second world war with strong legal powers to withstand government pressure, guarding against the excesses of the Weimar Republic and later the Third Reich. Germany's Weimar hyperinflation in the 1920s was part of a grim chain of money printing episodes ruining currencies and breaking political systems – linking ancient empires to modern emerging markets like Argentina, Venezuela and Zimbabwe.

Established in 1998, the European Central Bank was modelled on the Bundesbank, with its independence enshrined in the European treaties. Now, the model appears to be faltering. Conservative Germans voice concerns that enormous central bank government bond purchases before and during the Covid-19 upheavals (Figure 1) are turning these institutions into appendages of finance ministries.

In recent months, including in an OMFIF meeting in November, Jens Weidmann, the Bundesbank president and former adviser to Chancellor Angela Merkel, has spoken of a 'dangerous dynamic' of 'fiscal dominance'. He outlines how central banks risk surrendering independence as they 'jump to the rescue', becoming permanent buyers of debt issued by big-spending governments unfettered by market discipline.

To many, in Germany and beyond, such talk is alarmist and exaggerated. François Villeroy de Galhau scotches fears that the ECB is in danger of losing clout. At an OMFIF session in September the silken-tongued Banque de France governor countered traditional German views by suggesting the ECB should more directly widen its mandate beyond targeting purely price stability. The Bundesbank, once a synonym for German monetary hegemony, has lost sway with the birth of the EMU. Weidmann has maintained opposition to some of the ECB's furthest-reaching credit-easing actions. Yet he has accepted that the Bundesbank generally must give way to a built-in majority on the 25-member ECB governing council favouring a relatively accommodative monetary stance

Mario Draghi, ECB president in 2011-19, was frequently embroiled in disputes with the Bundesbank chief. Draghi's successor, Christine Lagarde, a former French finance minister and International Monetary Fund managing director, has taken a far more



1. Central bank balance sheets have exploded

Asset purchases by selected central banks, $tn

Source: respective central banks, OMFIF analysis

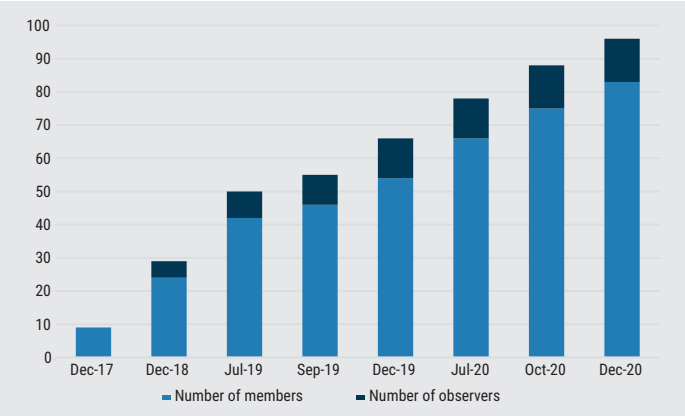
consensual line to heal rifts between council 'hawks' and 'doves'. But Lagarde has dropped not-so-subtle hints that quantitative easing purchases of government bonds may continue indefinitely.

One leading southern European governor on the ECB council fiercely opposes his colleagues calling for a gradual credit tightening as Europe slowly brings the pandemic under control. 'I am a strong hawk,' he tells OMFIF, 'in opposing deflation.' There were sharp exchanges at the ECB's meeting on 10 December when it decided to boost emergency bond buying by €500bn and extend it to March 2022. Council members swapped jibes about whether the ECB was taking seriously its mandate to boost inflation to 'below but close to 2%' – a level it has undershot for eight years.

Marcel Fratzscher, a former ECB official who heads the Berlin-based German Institute for Economic Research (DIW) believes the Bundesbank's narrative on inflation and independence is overdone. Fratzscher echoes a persistent Lagarde theme: the need for coordination between central banks and governments. As Lagarde puts it: 'Fiscal policy empowers monetary policy by fostering demand ... And monetary policy makes fiscal policy more effective.'

Fratzscher tells OMFIF: 'It is good to have implicit co-operation between monetary and fiscal policy. This is not a loss of central bank independence. Even if central banks were unhappy with fiscal polices, they would be breaching their mandate if they raised interest rates to force governments to change their behaviour. It's not the job of central banks to discipline governments.' He adds, 'If inflation were to rise for a sustained period substantially above the ECB's mandate, then it would have to act decisively, and I am sure it will.'

Behind the divergences over 'harmonisation' lies a deeper question. European governments have still not resolved whether, longer term, the euro area requires a fully-fledged political union to back the ECB's monetary integration. According to German critics, a transformation towards a system for permanently channelling wealth and income from higher- to lower-performing areas of the EMU may be on the way.



2. Growing NGFS signals central banks' commitment on climate change

Number of members of Network for Greening Financial System since 2017

Source: NGFS, OMFIF analysis

'WHEN INFLATION STARTS TO RISE AGAIN, CENTRAL BANKS WILL BE UNABLE TO TIGHTEN MONEY IN RESPONSE.'

CHARLES GOODHART

Helmut Schlesinger, former Bundesbank president, at 96 a Methuselah of monetary orthodoxy, tells OMFIF: 'I am worried there is no real resistance to the ECB's very large purchases of government bonds, which represent a form of state financing not allowed by the treaty. It seems to me that Chancellor Merkel and her government didn't recognise the concerns raised in this matter in May by the German constitutional court [when it voiced concerns about illegal monetary financing].'

He adds: 'There seem only two or three members of the ECB governing council who speak out against these policies. The close linkage between fiscal and monetary policies presents a danger for the independence of the ECB. This danger is intensified if the ECB is following too many targets in the political field, for example in measures to alleviate climate change, (Figure 2) which weaken the focus on its primary goal of stability.'

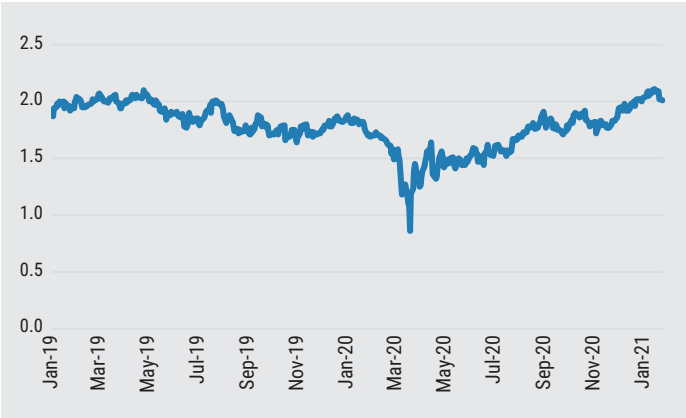
Barry Eichengreen, economics professor at the University of California, agrees with the second part of Schlesinger's argument. He backs the Lagarde and Fratzscher view that central banks can retain independence under fiscal and monetary policy harmonisation. He adds: 'My worries about independence stem not from concern about fiscal dominance, more because of the range of non-traditional fields that central banks now seek to address, such as climate change measures and gender balance. They are dabbling in issues that are more difficult to control, measure and communicate.'

Underlining the diversity of opinions, Athanasios Orphanides, a former governor of the Central Bank of Cyprus and member of the ECB's council, complains the ECB has used the broad language of the European treaty to set its own goals, for example in defining 'price stability' - and yet has not done enough to produce higher inflation.

He tells OMFIF: 'Central banks should have the independence to meet their goals but not to set them. The ECB has too much independence and insufficient accountability.' He claims that the ECB has misused independence by following overly tight Bundesbank-style policies that have

'THE CLOSE LINKAGE BETWEEN FISCAL AND MONETARY POLICIES PRESENTS A DANGER FOR THE INDEPENDENCE OF THE ECB. THIS DANGER IS INTENSIFIED IF THE ECB IS FOLLOWING TOO MANY TARGETS IN THE POLITICAL FIELD.'

HELMUT SCHLESINGER



3. US implied inflation expectations climbing

5-Year, 5-Year Forward Inflation Expectation Rate, Percent, Daily, Not Seasonally Adjusted

Source: Federal Reserve, OMFIF analysis

raised euro area credit spreads and damaged growth. Now a professor at Boston's MIT Sloan School of Management, Orphanides – who previously worked at the Fed – stresses the contrast with the US: 'If the Fed starts making systematic policy errors, Congress can change the law and hold the Fed accountable. The ECB should not be so independent that its policy errors cannot be corrected.'

The ECB's framework is coming under renewed scrutiny in the bank's strategy review due to be unveiled in early September. The process gives Weidmann and other governing council hawks unaccustomed influence. Otmar Issing, the ECB's first board member for economics, oversaw the only other previous review in 2003. He points out how the council's stringent minority – normally submitting to the majority on operational decisions – will have an effective veto on the outcome of the strategy review, including on the hot topic of climate change, where Weidmann and other orthodoxists oppose interventionism that could expose the ECB to conflicts with its monetary goals. 'The review should end in unanimous support for the decision,' Issing tells OMFIF. 'This will not easily be achieved. Compromises are needed, but the result must deliver a consistent approach.'

The review is expected to result in 'not too much change' in its inflation framework, Issing says. The 2003 review upheld the ECB's 1998 definition of price stability as an inflation rate of below 2% over the medium term, but added the refinement of 'close to' to safeguard against deflation. He believes the ECB will not signal it is going soft on inflation. 'This time I believe the ECB might simply settle on a figure of 2%. The question is: Will the ECB see this goal as symmetric, i.e. will it deal with both overshooting and undershooting in similar fashion.'

The fundamental problem facing central banks has been recognised for years: they are operating in too many fields. As veterans like Schlesinger and Issing emphasise, the widening of central banks' sphere of action since the 2008 Lehman Brothers bankruptcy into areas like banking supervision, as well as large-scale QE, has limited their room for manoeuvre. A 2012 OMFIF-EY report, 'Challenges for central banks: wider powers, greater constraints', underlined far-reaching questions about their operational freedom.

The LSE's Goodhart sees the threats growing mainly outside Europe. 'The central banks in Japan and India have lost their independence, Latin America never had it, the US is on the verge of losing it. The independence of the ECB is protected by treaty – but I'm more worried about Jay Powell.' Faced with Yellen in the Treasury, Goodhart says fiscal dominance seems on the way in the US. 'I think he will do whatever she likes.'

As for inflation, Goodhart thinks it's on the way back – a view gaining ground because of the Biden recovery plan, signalled by rising longer-term US interest rates (Figure 3).

'CENTRAL BANKS SHOULD HAVE THE INDEPENDENCE TO MEET THEIR GOALS BUT NOT TO SET THEM.'

ATHANASIOS ORPHANIDES

'Once vaccination has overcome the Covid-19 pandemic, say by summer 2021, a surge in consumer expenditure and demand could lead to a blip in inflation. If that does not exceed 5%, central banks will probably welcome the counterbalance to the previous undershoot, claiming it is purely temporary.'

More likely, Goodhart believes, is that inflation will remain significantly higher than targeted in 2022-23. This will lead to different scenarios including conflict with politicians, most of them with unpleasant outcomes. 'Ultimately the political authorities have the whip hand, whether in authoritarian or democratic countries. Central banks must be aware where their limits lie.' ●

David Marsh is Chairman at OMFIF.

ECB MAIN TASK IS TO FOLLOW RIGHT POLICIES

FEARS OVER FISCAL DOMINANCE AND MARKET NEUTRALITY ARE MISGUIDED

DANAE KYRIAKOPOULOU
OMFIF

Vaccines are a light at the end of the health crisis tunnel. But the economic effects of Covid-19 remain longer lasting. Even with the pandemic emergency purchase programme, asset purchase programme and targeted longer-term refinancing operations on the European Central Bank's table, there are limits to what monetary policy can contribute to Europe's recovery. Targeted fiscal support remains the most powerful tool to address the pandemic's economic ramifications.

However, there are worries over 'fiscal dominance', whereby monetary policy is forced to accommodate high levels of public debt. In his OMFIF speech in November, Bundesbank President Jens Weidmann stated that central bankers need 'to make it very clear that we are not going to place monetary policy at the service of fiscal policy', cautioning that 'if we create a different impression, we are putting both our independence and our credibility at risk' (See this quarter's Bulletin poll, on page 38, to learn if OMFIF members agree with Weidmann). Former ECB Executive Board Member Otmar Issing argues that 'central banks are caught in a trap of their own making' and wonders whether 'they will be able to escape the regime of fiscal dominance and retain their independence'.

Such fears are misguided. True, the pandemic is strengthening links between fiscal policy, monetary policy and government debt management. But central bank independence is rooted in institutions' ability to deliver stable prices when there are calls for economically unjustifiable stimulus. This ability is preserved by pursuing the right policy options and delivering results, not by refraining from doing so to defend a reputation for independence for independence's sake.

As ECB Executive Board Member Isabel Schnabel says, the euro was built on the principle of 'monetary dominance', with the central bank's objectives 'determined by its mandate as defined in the European treaties'. So long as bond purchases make economic sense, central bank credibility is not at risk. And in today's context, they do. Interest rates are at the lower bound, leaving asset purchases key for delivering price stability.

> 'FEARS ABOUT CENTRAL BANKS LOSING THEIR INDEPENDENCE THROUGH FISCAL DOMINANCE OR LOSS OF MARKET NEUTRALITY ARE MISGUIDED. WORSE STILL, THEY CAN BE DANGEROUS IF THEY DISCOURAGE THEM FROM PURSUING THE RIGHT POLICIES.'

The same applies to another source of fear: climate change action. So far, this has focused on supervision. Few have addressed climate risks in their own portfolios, whether in reserves management or asset purchases.

For the ECB, this is due to the 'market neutrality' principle that guides its corporate sector purchase programme to be in proportion with the market. Given the concentration of carbon-intensive industries in the corporate bond universe, this has resulted in a carbon-biased portfolio.

The ECB should rethink market neutrality. Both Schnabel and President Christine Lagarde have pondered whether such assets should be eligible for the ECB's risk-constrained investment universe. Lagarde warned of market failure and suggested that financial markets may 'not actually be measuring the risk properly'.

Others are more sceptical. Weidmann, while acknowledging that 'central bank independence is not an excuse for inaction', has insisted that 'it is not up to them to correct market distortions and political actions or omissions'. He questions whether 'central banks should become engulfed in politics and undermine their own independence'. Instead, he argues that governments should adjust carbon prices. Governments have yet to do so but have committed to action through the Paris agreement. Central banks evaluating the risk of assets in their portfolios can assume that the prices are heading in one direction only – and it is not one that justifies their presence on the ECB's CSPP.

By focusing on 'market neutrality', the ECB may be missing a chance to reduce portfolio risks before a sudden reversal prompted by excessive bullishness – economist Hyman Minsky's feared 'Minsky moment'. In taking action to address market failure central banks are not playing politics and sacrificing independence. Rather, they are protecting balance sheets against underpriced risk.

Misguided fears about waning independence through fiscal dominance or loss of market neutrality can be dangerous. Such concerns could discourage central banks from pursuing the right policies. By using the tools appropriate for the conditions, central banks will enhance, not lose, credibility and independence. ●

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

SCEPTICISM OPENS DOOR FOR CRYPTOCURRENCIES

CENTRAL BANKS COULD BE OVERTAKEN BY PRIVATE SUBSTITUTES

STEVE HANKE
JOHNS HOPKINS UNIVERSITY

When delivering the BBC's 'A Question of Trust' Reith lectures in 2002, Baroness Onara O'Neill recounted advice given by Confucius to his disciple, Tzu-kung. He revealed that a government needed three things to survive: weapons, food and trust. If a ruler cannot hold onto all three, which one should be given up first? For Confucius, weapons were the most expendable, and then came food. But a ruler should attempt to hold onto trust at all costs, for 'without trust we cannot stand.'

This is widely understood by central bankers. But few have been able to implement policies that have garnered much trust, particularly in the modern era of fiat money—and for good reason. Over the past 120 years, central banks have produced a great deal of inflation, which has been accompanied by a loss in the purchasing power of their currencies. At times, bouts of hyperinflation have reared their ugly heads. Currencies have been rendered worthless overnight.

Consider what has happened in Venezuela, Zimbabwe and Lebanon during the past year. On 31 December, I measured the annual inflation rates in those top three inflators to be 1,945%, 395% and 274% respectively. Inevitably, the bolivar lost 94.5% of its value against the dollar last year, the Zimbabwean dollar lost 79.5% and the Lebanese pound lost 72.6%. It is difficult to trust central banks that issue currencies such as these.

There are exceptions, but very few. The most notable is the Swiss National Bank. In the last 120 years, Switzerland has experienced the world's lowest average annual rate of inflation. Unsurprisingly, the Swiss franc has appreciated against all other currencies over that period. In consequence, unlike most central banks, the SNB commands a great deal of trust.

'MONEY EMERGED UNPLANNED OUT OF PEOPLE'S ATTEMPTS TO IMPROVE THEIR CONDITION BY MOVING AWAY FROM BARTERING AND BY ENGAGING IN INDIRECT EXCHANGE VIA MONEY.'

CREATING ORDER

The public is always in search of alternative institutions and reliable arrangements that work. Carl Menger, founder of the Austrian school of economics, formulated the process by which institutions are created and evolve. This has come to be known as spontaneous order, an order that is not consciously designed by anyone. For example, a V formation of migrating geese does not exist because one goose ordered it. Menger demonstrated that it was spontaneous order that gave rise to money. No one invented money. Instead, money emerged unplanned out of people's attempts to improve their condition by moving away from bartering and by engaging in indirect exchange via money.

This brings us to the rise of cryptocurrencies. Lack of trust in central banks and national currencies set the stage for the spontaneous arrival of private substitutes. While technology played its part in making cryptocurrencies feasible, it is the lack of trust in central banking that has paved the way for what might be a new spontaneous order. ●

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

The end of Covid? The return of inflation? The rise of digital? Our panel of experts predict what what will define the year ahead

OUTLOOK 2021

What next for reserve managers?

Central bank portfolios have moved into more assets than just government bonds, but further diversification looks essential, writes Massimiliano Castelli, head of strategy, sovereign institutions at UBS Asset Management.

OVER the last decade reserve managers have increased diversification. A growing number of central banks are now investing across a wider range of asset classes. According to the most recent UBS Reserve Management Survey, in 2020 more than 90% of central banks surveyed are invested in US agencies, two-thirds are invested in corporate bonds and nearly half of those central banks surveyed are eligible to invest in listed equities. Reserve managers' portfolios look increasingly similar to those of other institutional investors such as pension and insurance funds.

The sharp market sell-off in February/March 2020 was the first big test of market stress faced by reserve managers since the 2008 financial crisis. And the test was successfully passed. According to the UBS RMS Survey, nearly half of central banks that are invested in equities rebalanced their equity holdings to return to their equity allocation target. And more importantly, while a shift to more 'defensive' assets is visible in 2020, the 'secular' trend towards diversification remains intact with equities now being an eligible asset class for about 45% of central banks, a new all-time high.

The diversification of reserves away from government bonds has been a winning strategy so far. Since 2009, according to our estimations, a liquid portfolio invested 50% into cash and government bonds from advanced economies, 35% into investment grade spread products and 15% into advanced economies' listed equities which generated a return of more than 4%. Reserve managers adopting diversification have been able to fulfill their policy goals including liquidity preservation, capital protection and return.

While the inclusion of equity requires an increase in risk limits in terms of maximum drawdown, the volatility of the entire portfolio increases only slightly when compared to a fixed income-only portfolio. This is a result of benefits generated by the inclusion of equity in a portfolio dominated by fixed income assets.

So what's next for reserve managers? The main challenge currently faced by reserve managers is the low yield environment. According to the UBS survey, the majority of institutions surveyed expect interest rates in the US and the euro area not to start rising before 2023 as central banks maintain a very loose monetary policy stance in the post-Covid world.

This will lead to a dramatic fall in returns on reserves when compared to the last decade as the fixed income boom ends. According to our estimates, in the next five years a portfolio invested into investment grade fixed income assets only will generate a return below 1%. Even a portfolio diversified into equities – as the one discussed above – will generate a return of less than 2%, less than half the return generated since 2009 and lower than inflation.

Reserve managers face a choice: either accept much lower returns than in past, failing to protect the real value of their reserves, or continue along the diversification path. Reserve managers who are pondering further diversification steps should consider: further diversifying away from advanced economies' government bonds; increasing allocations to Chinese and other emerging markets bonds; increasing allocation to equities to above 20%.

> 'Reserve managers' portfolios look increasingly similar to those of other institutional investors such as pension and insurance funds.'

Central banks with high levels of reserves and less liquidity constraints should consider allocations to real estate and infrastructure to enhance returns and generate further diversification benefits.

According to our estimates, over the next five years a portfolio with emerging market bonds (in hard currency) at 15% and equity at 20%, with the rest in government bonds and investment grade spread products, will generate a return of 2.4% with a volatility still below 5%. That is less than in the past, but capable of protecting the real value of accumulated reserves. ♦

Digital dynamism will fuel Asia's outperformance

A week-long trial of a central bank digital currency in Shenzhen may have been a glimpse of the future, writes Taimur Baig, chief economist at DBS Bank.

FROM digital bank licence approvals in Singapore to the roll-out of the e-RMB initiative in China, digital finance picked up momentum in Asia through the year of the pandemic. Just like the rest of the world, the pace of e-commerce adoption soared as consumers and businesses favoured remote transactions. Monetary authorities in Australia, Cambodia, China, Hong Kong, Singapore, South Korea, and Thailand made forays in central bank digital currencies, launching pilots to explore legal framework, settlements, and cross-border payments.

The developments in China are particularly noteworthy. In October, over 47,000 consumers in Shenzhen spent Rmb8.8m at 3,389 designated shops during a week-long trial of People's Bank of China's digital currency. Users also transferred credit into the official digital Renminbi app, which can be used well after the end of the trial.

Tests have also taken place in Suzhou, Chengdu and Xiongan. In Suzhou, the e-RMB has been used for paying salaries to some public servants, while in others the focus has been on retail. More than Rmb2bn has been spent using China's new digital currency in 4m separate transactions, according to the PBoC. The next batch of pilot programmes will likely include other major metropolitan areas such as Beijing, Tianjin, Shanghai, Guangzhou and Chongqing. A countrywide launch by the 2022 Winter Olympics in Beijing is on the cards.

PBoC is working with lifestyle apps, including ride-hailer Didi Chuxing and food delivery company Meituan, with plans to make the digital currency available for online transactions in the upcoming experiments. The authorities are also testing new functionalities like offline, phone-to-phone (just by tapping one device to the other) transfers. Indeed, the next step could be to provide access to e-RMB even without a phone number or bank account information. This makes sense since CBDC is legal tender that can be exchanged without needing a bank as an intermediary. Such a development could facilitate CBDC use by foreigners, who can directly exchange foreign currencies for the digital yuan without carrying cash or opening an onshore bank account.

While China's public and private sectors continue to lead in the area of digital currency usage, interesting developments are afoot elsewhere too. The National Bank of Cambodia recently launched the Bakong payment system, a common platform for commercial banks, microfinance institutions and payment service providers to deliver e-wallet and money transfer services to consumers without the need for a bank account. It facilitates transactions in both dollars and riel by scanning QR codes or inputting the phone numbers of payees. The platform should simplify payments and promote financial inclusion.

We expect 2021 to be a year of Asian outperformance as the region surfs a favourable trade cycle, successful pandemic management and pull from an accelerating China. Digital finance developments will be a constant, adding dynamism to the world's growth engine. ♦

'The developments in China are particularly noteworthy. In October, over 47,000 consumers in Shenzhen spent Rmb8.8m at 3,389 designated shops during a week-long trial of People's Bank of China's digital currency.'

Biden must adopt multilateral tactics for China policy

Relations between the US and China will remain fraught, albeit more diplomatic, writes Nathan Sheets, chief economist and head of global macroeconomic research at PGIM Fixed Income.

AS recently as five years ago, there was a vigorous debate in Washington regarding US policy towards China. Today, that debate is over. The broad consensus – among both Republicans and Democrats – is that the US-China relationship is necessarily one of 'strategic competition'. The US must lean against China's rise using the broad range of tools at its disposal.

Some advocates of this view highlight the trajectory of China's policies under President Xi Jinping – including the stunted progress in establishing a level playing field for foreign firms, China's handling of foreign technologies and (more recently) the actions against Hong Kong. Others argue that previous efforts to bring China into the global system were fundamentally misdirected and that Xi's actions are only the latest wake-up call.

The wind was blowing in this direction even before Donald Trump's ascent to power, but he effectively tapped into the zeitgeist and gave it voice. Even so, Trump's tactics failed to win broad support. His trade war, sanctions against Chinese technology companies and other restrictions have been criticised as hurting the US as much as China. The pain has been amplified by the unilateral nature of the actions.

The Biden administration is expected to pursue an alternative path. US concerns about Chinese actions are broadly shared by many other countries. The US has scope to work with its allies to press China to reform and open up. Broad-based diplomatic efforts could seize the moral high ground and intensify pressure on China.

What this looks like in terms of concrete policy measures remains an open issue. It will clearly entail 'multilateral jawboning' but could also include increased coordination on tariffs, sanctions and policies on Chinese investment. It may prompt the Biden administration to pursue new (or expanded) trade agreements, potentially including renewed discussions with partners in Asia, Europe and on World Trade Organisation reform.

That said, two caveats are necessary. First, given US political realities, it would be difficult for the Biden administration to roll back quickly the tariffs and other measures that Trump has put in place. Second, the recent comprehensive agreement on investment between the European Union and China was no doubt a disappointment to the Biden team, but the scope for broad co-operation with the US persists nonetheless.

US-China relations are to remain fraught. The Biden administration will continue to press China, but its tactics will be more multilateral in nature. Whether this approach will be more successful than President Trump's efforts remains to be seen. But, at a minimum, it will be more consistent with the traditional role of the US as a global leader and restore a measure of normalcy to US economic diplomacy. ♦

After Covid-19, we require a new form of finance

As calls from both inside and outside of the sector grow louder, banks need to play their part in socially-responsible growth, writes Joseph Ding, senior researcher at China Construction Bank University in New York.

THE Covid-19 pandemic has revealed fissures in the social fabric of economies developed or developing, big or small. The financial industry, thanks to its relatively early and broad adoption of technology and strengthened balance sheets following the 2008 financial crisis, has so far seen relatively few business failures. In fact, many banks have posted healthy profits throughout 2020, even while setting aside provisions for future non-performing loans.

The stark contrast between exuberant equity markets and the dire state of the main street economy has brought a renewed sense of urgency in calls for social responsibility, sustainable growth and stakeholder capitalism. But it's not just outside activists who are the leading voices. Industry leaders such as Bank of America's chairman and chief executive Brian Moynihan are among the most powerful advocates for responsible banking.

It is also a global trend. In Asia, leading financial firms such as China Construction Bank have laid out a vision of 'new finance', calling for a deeper impact and longer-term effectiveness of financial inclusion to address social inequality and the misallocation of resources. At the heart of this vision lie the democratisation of digital technology. Fintech and financial inclusion become the core long-term growth strategies, and are embodied in many large-scale inclusive service platforms. These innovative platforms, implemented with nascent technologies in Cloud, Big Data and artificial intelligence technology, enable lenders to analyse huge amounts of data from disparate sources, and generate a multi-dimensional profile for proactive credit and risk models. These reflect customers' credit-worthiness and risk characteristics in an accurate and holistic manner.

'Hui Dong Ni' and 'Yu Nong Tong' are two such examples from China Construction Bank. The former, meaning 'Benefit follows you', is an inclusive finance mobile app that services a diverse group of SMEs and retail customers from start-ups to farmers to those closer to the poverty line. Key features such as two-way interaction, 'one-minute' approval and a 24/7 service with complete on-line process and costs transparency, have elevated 'Hui Dong Ni' to be an industry-leading platform with 77 built-in inclusive finance use cases, 11m registered users, 3.6mcertified corporate customers, and over RMB250bn in total credit approvals.

The Yu Nong Tong platform is dedicated to the agricultural sector and carries relevant educational content as well as low-cost credit products for farmers. It operates nationwide in China and has over RMB2tn in total loans outstanding.

The demand for such products and services could not be clearer. The challenge now is to build on what has been achieved in the Covid crisis. The key to this lies in collaboration: industry leaders must work together to reshape the next generation of finance, where technology and financial inclusion are the recipe for a socially-responsible and sustainable path to long-term growth. ♦

'Industry leaders must work together to reshape the next generation of finance, where technology and financial inclusion are the recipe for a socially-responsible and sustainable path to long-term growth.'

Making diversity count

The investment industry can make a transformative contribution to society and itself by embracing a diverse workforce, writes Hani Kablawi, head of international, BNY Mellon.

THE investment industry leads others at measuring performance. These metrics are both financial, like investment portfolio returns, net flows, gross revenues and earnings, and non-financial, such as client satisfaction, technology and operations resiliency, and employee engagement scores.

Investment firms are increasingly aiming for more diverse workforces and are applying rigour to measuring and tracking this. A growing weight of evidence supports the business case for a diverse workforce. Employees from different backgrounds bring new experiences and perspectives, helping create organisations that are more resilient, innovative and profitable.

A 2019 McKinsey report reveals a clear correlation between diversity on executive teams and financial outperformance. It found that executive teams in the top quartile for gender diversity and their companies outdid those in the bottom quartile by 25% in profitability. Similarly, companies in the top quartile for ethnically diverse executive teams outperformed those in the bottom quartile by 36%.

Driving diversity is not just 'right', it is also smart. At BNY Mellon, we have set ourselves clear goals and strategies to drive diversity. That starts at the very top. The board sets our targets and our chief executive officer holds the executive team accountable for achieving them. If our longer-term aspiration is to represent the communities in which we operate all around the world, we set ourselves goals that get measured and tracked, to make sure we are alert to them through hiring, retention and promotion decisions. Our executive committee members sponsor senior employees from different backgrounds to make sure we're constantly and consciously considering diverse talent for senior roles. And we require hiring managers to have diverse candidate slates and interviewing panels for all open positions.

As the saying goes: 'Diversity is being invited to the party and inclusion is being asked to dance.' We encourage our teams to join and lead employee resource group activities, and we give them the time, space and tools to work together to drive engagement around causes that are important to them. We ask managers to hold inclusion dialogues, train their teams to identify unconscious bias in themselves and expect all employees to become inclusion allies. Only when everyone feels included, do they belong, and when all 48,000 of our colleagues feel like they belong, that drives positive outcomes for all our stakeholders and for society.

We are on a journey and there is a significant way to go. Barriers remain to attracting diverse talent into an industry that may not be seen as a viable career option in some communities. As an industry, we need to change that by improving representation and creating more diverse role models.

The events of 2020 have highlighted the discrimination and social injustices that we would like to think were things of the past still exist. But at the start of 2021, I am optimistic about the transformative contribution the investment industry can make to society while strengthening itself with the greater experience, creativity and resiliency that a diverse workforce can bring. ♦

'The events of 2020 have highlighted the discrimination and social injustices that we would like to think were things of the past still exist.'

Making CBDCs a true and trusted currency

Digital currencies are coming, but lessons from experience with cash must be remembered, writes Wolfram Seidemann, chief executive officer of G+D Currency Technology.

THE race to issue a digital currency is on. Following the announcement of Libra (now renamed Diem) in 2019, the Covid-19 pandemic has given it fresh momentum and has reinforced the need for a ubiquitous public payment option. Nevertheless, digital currency is more than just another electronic payment method.

Currencies are the purest statement of trust that citizens make. They are not products, rather they are an expression of democratic values and faith in the issuing institution. It took centuries to establish the secure, resilient, universal and trusted basis for consumer payments that is cash. Since the outbreak of the pandemic, people have turned to cash, finding comfort in its security as a store of value and promise of freedom. More than one-third of people in the euro area keep a cash reserve at home, for example.

Cash's reputation must be kept when it becomes digital. A central bank digital currency could unite the speed and convenience of digital payments with the benefits of cash. Fundamental characteristics, such as privacy and data protection, also apply to digital cash and are necessary for public acceptance. Even though the impact on all players in the financial system must be considered, the citizen is at the centre. We should keep the properties that make people trust cash rather than letting technical discussions dominate proceedings.

Citizens' trust comes with ease of use and openness to new business models. When talking of 'programmable' currency, digital cash should not be overengineered and should be interoperable, without altering the currency itself. Defined technical layers should be open to outside innovation, novel business models (such as 'streaming money' where there is steady payment over the period a service is used) or entirely new ecosystems. The common denominator is the basic infrastructure - the definition and creation of a data format that represents value and is signed and issued by a central bank.

Even with academic research papers on CBDC piling up, questions remain: What about international acceptance of digital cash? How should we define its regulatory limits? These questions will need to be answered through experience, a process of learning and steady improvement.

One thing needs to be kept in mind: We don't have centuries to make CBDCs a reality. We need to pick up the pace and set off on the right course. We don't want to sleepwalk into an unwanted future. Using longstanding experience with cash and by adding the technological opportunities we have, there is a bright future for trusted digital cash. ♦

'A central bank digital currency could unite the speed and convenience of digital payments with the benefits of cash.'

Beware rising neutral rates

Central banks should be prepared to act promptly if they don't want more pain later on, writes James Sweeney, chief economist at Credit Suisse.

THE US military has traditionally attempted to stand prepared to fight two major wars at once. In that spirit, economic policy-makers should consider challenging tail scenarios in the pandemic recovery, even ones that are not supposed to happen according to certain models.

One worth attention is a rising neutral rate of interest (r*) amid public unrest, political turmoil and disappointing economic activity. Neutral rates are most likely to rise in a strong economy with soaring business and government revenues. However, there are other plausible situations.

What if full employment is reached during higher-than-expected inflation but economic rebalancing has heightened distributional tensions and led to public criticism of any potential fiscal or monetary policy tightening? And suppose that once monetary policy tightening begins it becomes clear short rates need to rise more than expected to keep inflation close to target. Would central banks tighten sufficiently, even if it meant increasing rates to levels that were implausible a few years earlier?

A sharp rise in apparent neutral rates happened in the US in the late 1960s. R* estimates from the Laubach-Williams model rose by about 1.5% in that period. However, this was the increase in the real rate needed to stop inflation from rising (at full employment), not what was needed to keep it at the initial level.

If something similar happens in the next few years, starting at a point of below neutral real rates and amid rising inflation, then the implied necessary nominal rate change could be large. Circumstances in the 1960s were different in many ways from now, but our knowledge of the future rates needed for stable inflation might be less than is implied from a parade of commentaries about how low interest rates will persist.

Many central banks are confident that they could stop inflation. They worry more about a limited toolset at the effective lower bound. History suggests, however, that inflation often emerges during periods of political interference. Central banks may tighten insufficiently because of miscalculated output gaps or poorly understood lags between churning economic dynamics and later inflation.

Rising long-term market interest rates would likely occur if central banks stopped buying bonds amid a rising neutral short rate. This would increase government debt service costs, but it would take years for such a change to drive budget deficits.

Two unknowns are, first, how sensitive economic activity will be to future interest rate increases and, second, how sensitive inflation dynamics will be to profound changes in the composition of government liabilities and bank assets, one-fifth of which might soon be interest baring Fed reserve balances, matched by rising bank deposits.

Future rate hikes might be an exceptionally unpopular option. The expectation of persistently low neutral rates is now embedded in the strategies of many businesses, financial firms and governments. This confidence in low future short rates is useful now through its effect of depressing long-term interest rates. But if investors and policy-makers are disabused of this idea at the same time, great turbulence will ensue.

Of course, overshooting inflation might be tolerable compared to other problems. But it is this that compels us to think about this scenario now. Although it is hardly an existential risk, from a financial stability perspective it could lead to great volatility.

If central banks don't respond to rising neutral rates with sufficient hikes, then inflation, asset price bubbles or disruptive late tightening would follow. It is possible that the economy's interest sensitivity has increased so that even a few hundred basis points of interest rate hikes could lead to a slowdown or falling asset prices.

This dark scenario is no one's base case and the most sensible objection to it is that yields and neutral rates won't rise without strong growth. But the 'wars on two fronts' idea reminds us that this objection is not a universal law. ♦

'Circumstances in the 1960s were different in many ways from now, but our knowledge of the future rates needed for stable inflation might be less than is implied from a parade of commentaries about how low interest rates will persist.'

Sovereign debt can boost euro's reserve currency status

Rising volumes, including new EU issuance programmes, are beginning to rival US Treasury market, writes Frank Scheidig, global head senior executive banking at DZ BANK and deputy chair of the OMFIF Advisory Council.

THE dollar's longstanding position as the dominant currency for capital markets, foreign exchange reserves and commodities pricing is being challenged once again. At the beginning of the century, some institutions tried to take on the dollar by promoting the newly introduced euro. The euro began its life as a reserve currency in 1999 claiming about 18% of global reserves. It peaked during the 2008 financial crisis when it represented almost 28% of reserves but fell back subsequently to around 20%. It gained its 10 percentage points boost from the dollar, only to surrender it to other currencies, including the Australian and Canadian dollars and the renminbi.

The volume and liquidity of fixed income markets, especially for sovereign debt, are crucial factors determining a currency's international importance as a reserve asset and in financial transactions. The euro is lagging in this regard. But now the European Union is launching two initiatives to cushion the effects of the Covid-19 pandemic and promote the transition to a climate-neutral economy. The 'Support to mitigate unemployment risks in an emergency' and 'Next generation EU' programmes have a combined volume of around €850bn. Adding the EU's macrofinancial and balance of payments assistance programmes, that amount is close to €1tn. Together with big sovereign issuers, such as France, Italy, Germany, and supranationals, including the European Investment Bank and the European Stability Mechanism, the euro-denominated sovereigns, supranationals and agencies debt asset class is becoming, for the first time, a serious challenger to US Treasuries and a true alternative for institutional investors.

As my OMFIF colleague Philip Middleton has pointed out, 'The combination of massive fiscal deficits, inflation and low Treasury yields may also diminish the currency's attractiveness as an investment class.' A further reason why the dollar may lose ground is that US adversaries and allies alike are averse to successive US governments' using the currency as a weapon to attain political and economic goals.

The greenback is, however, a long way from being dethroned. While a sufficient volume of euro-denominated sovereign bonds is available, the short end of the maturity curve is not adequately covered. There are not enough short-term sovereign euro instruments with maturities of a year or less, analogous to US Treasury bills, which the EU should introduce.

Another issue is the timing of the Intercontinental Exchange euro swap rate fixings. Currently these are published at 11.15 central European time, too late for many Asian investors to trade on. Earlier publication would support real economy euro trading and billing, as well as the liquidity of euro-denominated SSA and related debt markets.

Euro area governments will support the push to increase the euro's share in world reserves and turn it into more of a commodity currency, with oil and oil futures quoted in euro. The EU's two big programmes are important in building the necessary foundations, but more is required.

Euro area countries, as well as nations like Switzerland and the UK which are closely linked to the euro area, are likely to benefit if the euro expands as a reserve and commodity currency. But another challenger to the dollar is emerging – from China. Provided it becomes fully convertible, and international laws are fully applicable in China, the renminbi will go down a similar path. In future we may see a triumvirate of the dollar, euro and renminbi – bringing the three major global time zones, and the world economy, into better balance. ♦

'Euro area governments will support the push to increase the euro's share in world reserves and turn it into more of a commodity currency.'

Why rising public debt won't drive countries into difficulties

Borrowing taken out by nations to cover Covid-19 related costs won't be an issue once economies start to recover. The currency regime determines risk factors, writes Christian Kopf, head of fixed income fund management at Union Investment.

FISCAL efforts to contain the fallout of the Covid-19 pandemic are already fuelling controversy. In November 2020, the German supreme audit institution criticised the government's deficit as 'inappropriately high' and called on policy-makers to put the budget back on an even keel. At the same time, Gita Gopinath, the International Monetary Fund's chief economist, urged governments to refrain from withdrawing fiscal stimulus prematurely. Which is the right course of action? And is public debt spiralling out of control again, as was the case with Greece in 2012?

Four factors will determine public debt sustainability: the trend growth of economic output and the price level, borrowing rates and the government's deficit levels. Due to their aging populations and already elevated productivity, advanced economies have little hope of high future economic growth. Moreover, central banks have been unsuccessful in boosting inflation for years. The good news, however, is that capital market rates have fallen significantly. The average interest rate on the stock of government debt stands at 1.2% for industrialised countries and only 0.6% for Germany.

Despite last year's sharp increase in debt ratios, fiscal adjustments of less than 4% of GDP would be enough to close the debt sustainability gap in most countries. This should be feasible, particularly as tax revenues should rise and social welfare spending should decline as the economy recovers from the pandemic.

Rising debt levels alone won't drive a country into difficulties – the currency regime plays an important role too. While yields on Italian government bonds shot up at the start of the crisis in spring 2020, this was not the case in Japan, even with its far higher debt ratio. Japanese government bonds will remain the safest yen investments, even if public debt rises further. Investors in Italian government bonds, on the other hand, can switch to euro-denominated bonds of other member states of the currency union at any time, thereby triggering market turmoil.

This severely curtailed Italy's fiscal space. The European Council addressed this problem by establishing the European recovery fund in June 2020. Italy and other member states can now fund part of their budget with loans from the European Union and will also receive direct grants. Tensions in euro area capital markets eased significantly as a result.

By contrast, the government bond markets of countries such as Australia, Japan or the UK, which run large deficits funded in their own currency, never faced such tensions in spite of record-high deficits. The biggest risk associated with those markets is not government default but currency depreciation. ♦

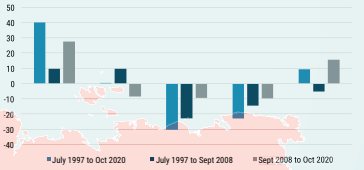
1: Only small adjustments needed for many countries

Forecasts for 2021	Government debt (% of GDP)	Budget balance before interest payments (% of GDP)	Average interest rate	Nominal trend growth	Required fiscal adjustment (% of GDP)
Australia	70%	-9.5%	1.6%	3.6%	8.3%
New Zealand	60%	-8.3%	0.8%	4.0%	6.8%
UK	112%	-8.1%	1.0%	2.9%	6.1%
Canada	115%	-8.2%	0.4%	3.2%	5.1%
US	134%	-6.9%	1.4%	3.1%	4.6%
Spain	121%	-5.1%	2.0%	2.8%	4.1%
Italy	158%	-2.8%	2.1%	1.6%	3.6%
Japan	264%	-6.2%	0.1%	1.1%	3.6%
France	119%	-5.3%	0.9%	2.4%	3.6%
Germany	72%	-2.7%	0.6%	2.8%	1.2%
Sweden	42%	-1.9%	0.2%	3.1%	0.7%
Switzerland	48%	-1.2%	0.4%	2.1%	0.4%
Portugal	130%	0.0%	1.9%	2.6%	-0.9%
Greece	201%	0.0%	1.5%	2.5%	-2.1%

Sources: International Monetary Fund, Union Investment, as of January 2021

Worldview

This season's expert analysis



10 reasons why renminbi will keep on rising

Bumpy road ahead, but room for further Chinese currency appreciation

David Marsh
OMFIF

In the months before the US presidential election, the general view took hold that, should Joe Biden win, one area of continuity with Donald Trump would be in policies on China. With the former vice-president moving into the White House, there will be tension over China's assertive foreign policy, human rights, trade, technology and espionage. But the relationship between the two major world players will be more organised, less chaotic and more stable than under Trump. Against this background, the factors behind renminbi realpolitik look positive. There will be plenty of bumps along the way. But here are 10 reasons why the Chinese currency's importance on the world stage is likely to rise.

1. Internationalisation brings geopolitical merits

China has recognised the geopolitical merits of attaining reserve currency status. As I wrote in a 2011 OMFIF paper, internationalising the renminbi 'would set down a convincing and consistent framework for China's financial interactions with the rest of the world.' China did a deal with Barack Obama's administration over admittance to the International Monetary Fund's special drawing right. Greater transparency and market-opening were traded for recognition as a member of the reserve currency 'club'. Broadly, the bargain has worked, although more needs to be done in advancing domestic market reforms.

2. Renminbi 'weaponising' fears overdone

International fears that the Chinese would attempt to seek a competitive advantage through currency devaluation have been scotched. Allegations that Beijing was manipulating the currency to maintain undervaluation may have been true in the past – but the period of steep foreign currency reserve accumulation ended in 2014. Compared with the period of maximum anxiety in autumn 2018 over fears the Chinese were depreciating for a competitive advantage, the renminbi has gained more than 4% on a real trade-weighted basis.

3. People's Bank aims to be Bundesbank of Asia

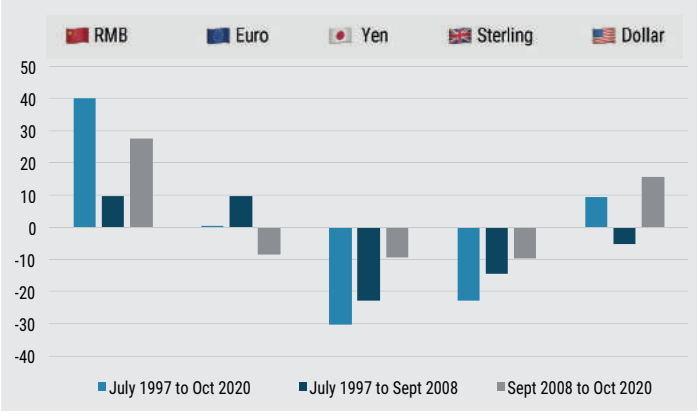
The People's Bank of China has recognised that renminbi appreciation would help control inflation as well as foster a shift focus away from external and towards domestic demand. This has been part of a long-term drive to gain political and financial clout; Beijing officials have spoken about making the PBoC the 'Bundesbank of Asia'. Following previous clear undervaluation, statistics show that the currency has risen 40% in real trade-effective terms since the 1997-98 Asian financial crisis and 28% since 2008 (Figure 1). The pace of appreciation will slow – but the legacy is likely to prove long-lived.

4. China only big country with 2020 economic growth

Although at the heart of the Covid-19 outbreak, China is the first major economy to escape from last year's severe downturn. It will be the only big country recording economic growth last year, at around 2%. It offers investors a positive interest rate and the prospect of some currency gain. The economy expanded 4.9% in the third quarter. This has allowed officials such as Yi Gang, PBoC governor, to exude strong elements of self-satisfaction: 'China's continued recovery will benefit the world.' Last year's growth has, however, been strongly export-led – a negative factor for the world economy, countering the effort to gear Chinese growth more to domestic demand.

5. 'Trade wars' with the US have led to export boom

China appears to have profited from 'trade wars' with the US. This has borne out predictions early in the Trump administration from Chinese officials that the president's policies would 'make China great again'. China's 2020 foreign trade surplus with the US is likely to be around $310bn, only a little lower than the $346bn



1: Change in leading currencies' real effective exchange rates

Present-day compared with Asia crisis (1997-98) and global crisis (2008-09), %

Source: Bank for International Settlements

in 2016. Chinese exports to the US in May-October 2020 were 4% higher than the same period in 2019, after both countries recorded steep falls in exports and imports over the previous three years. US exports to China were up 21%. Despite the rising renminbi, China's share of global exports is now at its highest on record. The risk for 2021-22 is that, as the Covid effect fades, market participants could cease to regard the renminbi as a one-way bet and the currency could fall again.

6. World asset managers move funds to China

US and other large asset owners, managers and banks are profiting from China opening its asset management and bond markets. October's oversubscribed $6bn China government bond offering, 15% of which was sold directly to US investors, was a signal of success. A €4bn offering in November drew €17bn worth of bids at declining yields – a further sign of Beijing's efforts to diversify funding sources and capitalise on foreigners' demand for higher-yielding instruments. The PBoC has been enacting measures since August to boost allocation of renminbi assets to foreign investors. A well-functioning liquid domestic bond market is a prerequisite for further currency internationalisation – an area where China has much ground to make up.

7. Reserve asset appeal rises from low base

Domestic bond market opening runs alongside efforts to increase the renminbi's appeal as a reserve asset. The euro, making up around 20% of world reserves, may make up some lost ground. But worries about uneven euro area recovery, negative interest rates and European Central Bank power struggles will hamper any advance. The renminbi starts from a much smaller base – 2% of world reserve assets – and therefore gains will be proportionately larger. Insufficient convertibility still holds it back. Yet the gap with both the US currency (61% of international reserves) and the euro is likely to shrink.

8. Wall Street firms counter financial 'decoupling'

Constraints on China's investments abroad have halted attempts to make a better return on its foreign assets. Beijing can be expected to seek understandings with the Biden administration to intensify beneficial technological exchanges. This will be important if the two countries stake out common ground on investments countering climate change. China's stock market offers foreign investors the chance to hedge their bets against overreliance on US tech firms. Access to the Chinese equity market will increase. Belying talk of financial 'decoupling', a host of Wall Street firms has been allowed to take control of their securities operations in China. Chinese companies' share listings in the US have accelerated during the Trump presidency. This may gain further momentum under Biden.

9. Ant setback shows drive to modernise markets

The 11th hour November move to suspend the $37bn listing of Ant Group was widely interpreted as a setback for capital market development. Despite the embarrassment for China, the Ant listing postponement may turn out to be a step forward. Beijing officials hailed the decision as safeguarding investors' interests. It was driven by a realisation that potential subscribers had not been sufficiently informed about Chinese regulators' rulebook changes likely to significantly impede Ant's lending business. The authorities are belatedly getting to grips with the complexities of running a modern international capital market. In similar fashion the much-publicised, ill-communicated renminbi 'devaluation' of August 2015 was blamed at the time for catalysing a mini-slump on global stock markets. The episode was re-evaluated afterwards as a necessary, if poorly executed, step towards a more market-orientated exchange rate framework.

10. Digital renminbi will advance Asia payments

The digital renminbi will be a major advance, especially for trading relations with Asian partners. Although worries about state control will impede some foreign usage, a digital currency will bring closer implementation of some longer-term strategic goals such the Belt and road initiative which Beijing officials described as a means of establishing a renminbi zone in Asia and beyond. The BRI is running into obstacles, with massive Chinese lending to over-indebted emerging market economies slowing dramatically, underlined by a Boston University study, and debt rescheduling looming. However, as Gary Smith wrote in an OMFIF commentary in November, 'Longer-term, the Belt and road will provide the means for an expanded use of digital renminbi for making international payments, and in particular, remittances. The dollar dominates BRI trade and remittance flows. Beijing will be happy to see the renminbi have an expanded role.' There will be Sino-American co-operation in many areas – as well as abundant power tussles. Depending on how seriously the Treasury and Federal Reserve take this issue under Biden, digital money may emerge as a notable battleground. ●

David Marsh is Chairman at OMFIF.

Don't overplay the dollar's decline in 2021

Expect some weakness, but there's little to suggest a sudden crash

Mark Sobel
OMFIF

Many observers are converging towards a downbeat 2021 outlook for the dollar. This view is associated with a surging risk appetite, the end of a strong dollar cycle or a twin deficit crash.

Given the seeming random walk nature of exchange rates, forecasting the dollar's 2021 outlook could be an act of hubris.

That said, the dollar may indeed fall this year, but an overly negative narrative is unwarranted. Many arguments for a future slump don't hold up.

First, the dollar is already falling sharply. The dollar index (DXY) in 2020 was down 13% from its March highs and around 7% for the year.

The Federal Reserve's trade weighted indices show less dramatic movements than the DXY – the dollar was down around 2.5% in 2020 (roughly 5.5% down against advanced economies and up 0.5% against emerging markets).

'The dollar may indeed fall this year, but an overly negative narrative is unwarranted. Many arguments for a future slump don't hold up.'

Second, as economies rebound from Covid-19, risk appetite will favour non-dollar currencies.

This plausible view needs to be tempered. America's growth potential is higher than Europe's or Japan's. Faster US growth often supports the dollar. Economic scarring could hold back the recovery. Even in a risk-on environment there will be bouts of volatility and risk aversion.

Third, easier US monetary conditions may trigger dollar selling.

Shifting interest differentials and relative monetary policy stances are exchange rate drivers. However, advanced economy central banks have slashed interest rates to the effective lower bound and are pursuing quantitative easing. Rate differentials are compressed. This won't change soon with central banks remaining on hold.

Even assuming significant dollar depreciation, Europe and Japan would fret about deflation and lost exports. The European Central Bank and Bank of Japan would turn toward further accommodation.

Cycles, deficits and appetites

Fourth, the strong dollar cycle is ending.

In recent decades, there were three periods of major dollar moves. In the late 1970s, the dollar plunged amid lost confidence in US economic policy. In the 1980s, the dollar soared after Paul Volcker tightened monetary policy to curb inflation. Before and after the global financial crisis, the dollar fell as the US pursued monetary accommodation earlier and more aggressively than others.

Dollar cycles last a decade or less. Indeed, the real trade weighted dollar has been on an upswing for the past eight years and is now on the strong side. But the dollar is nowhere close to peaks associated with past swings. It is still below its 1985 Plaza accord era peak and its 2002 top after the euro tumbled, and well above its post-great recession lows.

Fifth, US twin deficits will tank the dollar.

With the advent of fracking, the US current account deficit has remained around 2% of gross domestic product per year, though the Covid-19 pandemic will boost it. The US will run large fiscal deficits to overcome the crisis.

But America has the world's deepest and most liquid capital markets. It issues the world's leading safe asset – US Treasuries. Interest rates are rock bottom and the Fed will continue buying a large portion of US debt issuance. If demand abates, slight yield increases will draw inflows back.

Twin deficits might become an issue. In the meantime, America can well finance them.

Sixth, emerging market currencies may rise on strong risk appetite.

The outlook for emerging market currencies points to modest appreciation.

The renminbi is a good candidate for further appreciation. China's current account surplus is rising. The capital account has been bolstered by inflows attributed to high government bond yields and the inclusion of renminbi equities and bonds in global emerging markets indices. But authorities may become wary of further gains and allow more outflows.

The Mexican peso is to remain supported by high interest rates and the country's conservative stance. Asian currencies may experience upward pressures but will limit these.

Adding it up, the dollar's trade weighted index may well decline in 2021, but a crash does not appear likely. Of course, never ignore the random walk. ●

Mark Sobel is US Chairman of OMFIF.

Era of low inflation could last for 50 years

"We are in a new ruling financial environment"

Meghnad Desai
Chairmain, OMFIF
Advisory Board

Covid-19 has upended traditional economic thinking in a way that was even harder to anticipate than the virus itself. Economists were not prepared for a simultaneous supply and demand shock, alongside a deep fall in income and employment. The traditional Keynesian remedy does not work as the problem is not one of empty factories looking for demand. Factories cannot open if workers have to socially distance from one another. Consumers cannot congregate in pubs or restaurants either. Shopping is dangerous unless staggered in time and space. Only money issued by governments can sustain demand as well as supply.

The old rules no longer apply. Debt-to-gross-domestic-product ratios have been blown away, control over central banks monetising government debt has been swept aside and fiscal discipline put on indefinite leave. Governments are borrowing at unprecedented levels and still markets are lapping up their bonds even when they pay negative interest rates.

And yet, the expected alarm bells are not ringing. The ratio of debt servicing charges to GDP (which is a flow-to-flow ratio, and hence a more accurate one to follow than the debt-to-GDP ratio, which is a stock-to-flow ratio) is the lowest it has been for decades.

There is no inflation in the system. That apparent eradication of inflationary concerns became apparent in the middle of the 2010s. Central banks began to worry about inflation being below the target rate, and therefore how they might raise it, an unimaginable scenario for any economist! The reasons for this are complex: it may be in part be due to the transfer of wealth from the rest of the population to the rich, which has in turn distorted wealth distribution and led to over-saving. Today, a lot of money is chasing positive yields and settling for moderately negative ones.

Have we entered an era of zero or even negative inflation? If so, what are the reasons and how long will it last? Certainly, the link between government borrowing and inflation is broken.

Is this low inflation phase an exception or is it the new ruling financial environment? I am going to stick my neck out and say it will last for 50 years.

The elements of the low inflation economy have been maturing over the last 50 years - since the collapse of the dollar standard and oil price shock. Manufacturing has moved to Asia, away from developed countries. Services, transformed by technology, are enjoying rising productivity with better products being sold at lower prices. The prospect of inflation caused by the growth of unit labour costs is therefore, in the west at least, negligible. Rising oil prices are much less of a threat, thanks to the growth of alternative energy sources. Agricultural prices may persist as occasional sources of price shock, but they will be local or short lived.

Demographic growth is slowing down and, in some economies, labour shortages may yet cause problems. But the age of robotics is already with us, and the pandemic will encourage production by bodies unlikely to get sick or spread infection. Artificial intelligence is also supplanting skilled labour in many activities.

Should we suppose that we have entered an inflation-free world? One where money can be created by a click on a computer at the central bank, and no inflation follows. Could we afford a welfare state without a large tax burden? How would the global economy be reorganised? These are the next questions we will have to address if we truly have entered a new economic era. ●

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'The elements of the low inflation economy have been maturing over the last 50 years – since the collapse of the dollar standard and oil price shock.'

Why brown should be the new green

The most popular strategies might not be the most effective

Danae Kyriakopoulou
OMFIF

'Brown' or 'dirty' industries could become the most sought-after targets in capital markets. Investors focused on environmental, social and governance factors are concentrating increasingly on achieving impact through transition, rather than on minimising headline risk. They have much to gain from steering corporate shifts to more effective lower-carbon strategies. These more targeted strategies are set to take over tactics of blunt exclusions and integration through blended scores. Over the next two to three years, this could affect market dynamics significantly both in terms of asset classes and sectors.

Two factors are driving this. First, the motivations behind ESG investment are changing. Rising public interest in the climate agenda over the past two years has forced many to turn to ESG investing to manage reputation risk. This has created incentives for 'greenwashing', where pretending to do something is seen as better than doing nothing. Still, this has been a positive first step and it is important to raise awareness of climate change among investors.

'Rising public interest in the climate agenda has forced many to turn to ESG investing to manage reputation risk.'

To avoid headline risk, negative screening strategies are an easy first step, appropriate for social media- and headline-driven markets.

A 2020 survey of central banks, sovereign funds and pension funds by OMFIF and BNY Mellon showed that exclusions and ESG integration were the most popular responsible investment strategies.

But 'most popular' does not mean 'most effective', and effectiveness is becoming more important than popularity. The OMFIF-BNY survey found that public asset owners are increasingly drawn to ESG by superior risk-adjusted returns. The pandemic has sharpened awareness of portfolios' vulnerability to non-financial sources of systemic risk. The emerging consensus in OMFIF's Sustainable Policy Institute roundtables is that ESG is becoming more about protecting portfolios and less about promoting values or safeguarding reputations.

Sandy Kaul, global head of business advisory services at Citi, told an OMFIF panel, 'the whole approach around exclusions and integration of blended ESG scores is resulting in unclear linkages between the allocation of capital and the actual impacts on corporate behaviour that capital is helping facilitate.' A key issue is that such approaches usually evaluate companies based on their current performance (such as their carbon footprint). This is of limited use to determine a firm's preparedness to deal with future risks.

A shift in motivation is necessary but not sufficient to change behaviour. The second enabling factor relates to developments in disclosures regulation and data technology. Strategies that engage companies more directly have been primarily action- rather than outcome-oriented. This is changing.

Regulation such as the new European Union disclosure rules or the UK's November decision to move towards making climate disclosures mandatory, as well as emerging frameworks on materiality, will increase transparency.

Having information on specific ESG aspects will help issuers, companies and investors better understand and value portfolio risk. Improvements in technology are enabling investors to more accurately measure whether companies are creating positive impact, as documented in a September report by OMFIF and Refinitiv.

In an increasingly crowded space, a subtle alteration can significantly impact market dynamics. As investors become less reliant on blended scores and exclusions and better able to measure and tie capital to specific indicators and behaviours, the possibilities for ESG investing will grow. As Kaul noted, 'a lot of the companies that are being excluded today are probably going to become some of the most sought-after investment targets because they have the potential to change the most and therefore boost their underlying long-term valuation.' This is not to say that investors should look at 'dirty' sectors as good investments simply because they could improve.

The shift will be felt through the relative popularity of different asset classes: active ownership strategies have mostly been in equities. Bonds and structured loan products will have a greater impact if they are contractually tied to specific outcomes. Developments in ESG data will play a vital role in enabling this. ●

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

The case for a European banking charter

A new scheme could complete banking union, not undermine it

Ignazio Angeloni
Harvard Kennedy School and the Leibniz Institute for Financial Research SAFE

In 2012, the European Union launched the banking union to prevent devastating upheavals like the euro area sovereign debt crisis. In the background, however, lied a wider aim: helping euro area banks compete on a global scale. This required two steps. First, removing regulatory barriers which made cross-border activities unsafe and unprofitable. Second, setting up a single supervisory and crisis management framework. The second condition was fulfilled. The first was not.

Eight years on, despite the progress on fixing balance sheets, it has failed to meet its broader objective. Euro area banks are as national as they were, if not more. Troubled lenders have sought survival by shedding foreign operations. No relevant cross-border combinations have taken place. Banks with global ambitions are turning inwards. Meanwhile, European banks have lost market shares in areas like investment banking. All have reduced or closed their US operations. Their market valuations have fallen relative to competitors.

Yet opportunities abound for cross-border combinations. Large gaps in price-to-book values could boost the value of acquisitions. Mergers would lead to considerable synergies. There are still benefits to diversifying in the uneven euro area economy. In addition, digital transformation requires significant investments that only large banks can afford.

The obstacles are regulatory. Banks acquiring foreign subsidiaries or creating new ones face heavy macroprudential requirements. Cross-border participations in the banking union are treated as foreign, even though they are under the same supervisory umbrella. The law forbids intra-group cross-border capital movements. National ring-fencing hampers efficient liquidity management. Credit ratings penalise subsidiaries if the parent company is located in a country with a lower sovereign rating. I have suggested ways to revive the banking union. The European Commission may re-open the dossier once Covid-related concerns become less pressing. Even so, cross-border barriers won't disappear soon. In the absence of a mutualised deposit insurance scheme, countries will retain strong control over their banking sectors. A dispute on the treatment of sovereign exposures is blocking agreement on such a mechanism. But there is no need for sweeping regulatory changes involving banking union as a whole. Not all banks aspire to become global players. For those that do, a bespoke regime may be the easiest solution.

A possible scheme would use European regulation to create a legislative niche for banks that reach critical size and cross-border diversification thresholds. Banks gaining pan-euro status would have privileges as well as obligations. They would need to meet capital requirements set by the European Central Bank, at group level, on a fully-loaded basis. The group would follow, within the banking union, a single-point-of-entry structure, with losses up-streamed to the head company. The latter's liability structure would meet all loss-absorbing requirements set by the Single Resolution Board. Loss-absorbing rights and obligations across borders would be set by European law.

Dedicated deposit guarantee and resolution schemes would need to be carved out. As a result, credit ratings would become country-blind. Unlike other banks, pan-euro groups would be eligible to macroprudential requirements calculated by considering the banking union as a single jurisdiction. They would benefit from mobility of capital and liquidity within the group, subject to vetting. Preferably, their assets would be subject to a harmonised area-wide insolvency regime.

National laws could initially govern taxation and labour relations. Their impact on banks' profitability and cross-border functionality would need to be assessed, but once business can be allocated flexibly within the group, the relevance of these country-specific aspects would diminish.

This scheme would complete the banking union, not undermine it. European directives and regulations would still provide the umbrella for further bank harmonisation. ECB supervision would continue to contribute to a sound banking sector, based on common and transparent supervisory practices. In such an environment, mid-size banks wanting to grow further could more easily go for the final step, applying for membership in the pan-euro 'club'. ●

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'There is no need for sweeping regulatory changes involving banking union as a whole. Not all banks aspire to become global players. For those that do, a bespoke regime may be the easiest solution.'

A surge in inflation is on the horizon

Money supply growth will make an impact eventually

Juan Castañeda and Tim Congdon
Institute of International Monetary Research

Entering 2021, severe lockdowns have continued or been reinstated in large parts of the world's leading economies. However, several vaccines have been approved and extensive inoculation programmes are under way. The expectation is that normality should return well before entire populations are vaccinated, probably by summer 2021. In this scenario, large catch-up rises in demand and output are to be expected in the second and third quarters of this year. As emphasised in the Institute of International Monetary Research's monthly notes, the ultimate cause of inflation is excessive growth of the quantity of money. Given the extraordinary growth of money in 2020 in the US and, to a lesser extent, other major economies, the coming inflation surge will be significant and last for more than a few months. The final scale and duration will depend partly on the policy decisions made by major central banks in the next few months.

With the latest data available, the annual increase in M3 money supply in the US is still over 22%, while it stands at 10.5% in the euro area and 13.9% in the UK. These figures are incompatible with low and stable inflation in the medium term. Large and rapid changes in the ratio of money to national income do occur, but over the medium term the ratio of money to income tends to revert to a long-run average value, which reflects agents' stable underlying preferences to hold money. At present, households and companies have accumulated abnormally high money balances. Once the pandemic is under control in the second half of 2021, the return to pre-crisis patterns of money holding will result in them wishing to dispose of excess cash, leading to increases in demand and prices. Although monetary growth has decelerated in the second half of 2020 compared with March to June 2020, recent policy announcements signal further accelerations in money growth in the US and UK. In the US, another large fiscal package of $900bn has been approved by Congress, which will be mostly financed from the US banking system, along with the new economic relief bill for nearly $2tn which incoming President Biden will send to Congress.

In the UK, the second lockdown was accompanied by another £150bn of asset purchases by the Bank of England. Consequently, in early 2021, the annual rate of money growth in the US is likely to remain between 20% and 25%, and to exceed 15% in the UK.

The Federal Open Market Committee's minutes did not refer last year to any money aggregate, although the increases in both M1 and M2 (which are still published by the Federal Reserve) were extraordinarily high. By implication, the FOMC does not think that the money growth explosion of spring 2020 has any bearing on the medium-term macroeconomic prospect. No one denies that the relationship between money and the price level of goods and services is subject to a time lag that depends on the output gap, among other influences. A jump in money growth in an economy with abundant spare capacity and very high unemployment may therefore not lead to extra goods and services inflation for many quarters. But on the balance of probabilities – and hence our central expectation – the annual increase in consumer prices in the US, and probably the euro area and UK too, will exceed 5% before the end of 2022.

We can already see signs that higher consumer price index inflation is likely in the second half of 2021. Commodity price changes are good indicators of inflationary trends as they are not predictions but hard evidence based on actual prices. The Standard and Poor's GSCI has reported an annualised 250% increase in the last six-months. This is truly exceptional and central banks should take note that it foreshadows strong inflationary pressures. ●

'At present, households and companies have accumulated abnormally high money balances. Once the pandemic is under control in the second half of 2021, the return to pre-crisis patterns of money holding will result in them wishing to dispose of excess cash, leading to increases in demand and prices.'

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/

Shedding light on China's capital inflows

Numbers offer insights into Chinese authorities' strategy

Herbert Poenisch
Formerly Bank for International Settlemnets

'A stronger renminbi should help the currency's internationalisation, as holders of renminbi assets will be rewarded. For the partner countries in Asia as well as Belt and Road countries this means a sharper choice between following the dollar or the renminbi.'

Last year saw massive portfolio investment flows into China. This has been driven by the Chinese economy's bright prospects and higher returns on investments, as well as the country's financial opening up and expectations that the renminbi will appreciate. The exact amounts are unclear.

According to the People's Bank of China, foreigners increased their holdings of Chinese financial assets from January to September by $204bn. Of these, equities went up $94bn and debt securities $110bn. At 4%, these holdings represent a small share of total equities and debt securities, and are therefore unlikely to affect prices in the market. The share is higher for government bonds at 9% than for corporate bonds at 1%. Foreign exchange reserves and the balance of payments are not fully reflected in these figures, as some investments might be reinvested in China instead of crossing the border.

Over the same period, China's official foreign exchange reserves went up by a comparatively modest $27bn, to $3.142tn from $3.115tn. This seems to suggest that the massive inflow was absorbed by the exchange rate and non-official holders rather than as addition to foreign exchange reserves. During this time, the renminbi rallied to Rmb6.5 against the dollar, from close to Rmb7, an appreciation of 7.7%. Markets could start driving China's exchange rate.

In the balance of payments portfolio, liabilities rose by $66bn in the second quarter. This followed a trend from mid-2019, with inflows of $44bn in the second half of that year. The first quarter of 2020 was a slight reversal of this trend. Foreign direct investments inflows and outflows were roughly balanced. However, other investments, such as overseas currency and deposits, loans and trade credit expanded by $61bn, indicating a repatriation of incoming funds. This occurred in the books of financial intermediaries rather than in the official sector.

While this is not a complete picture, it offers some insights into Chinese authorities' strategy. First, they are not worried about renminbi appreciation or repercussions for the export sector. They want to demonstrate that renminbi investment is a two-way bet, encouraging market participants to hedge their foreign exchange positions.

Second, the inflows allowed Chinese financial intermediaries to increase their overseas holdings and lending without affecting foreign exchange reserves or the monetary policy framework.

Third, these moves demonstrate that China's capital account is opening up, though more on the capital inflows which are more or less liberalised than on capital outflows. While official institutions face hardly any restrictions on outflows, private residents are still subject to an annual $50,000 limit.

Fourth, renminbi appreciation helps Chinese borrowers repay debt securities. Close to $10bn in offshore corporate bonds, where stress has emerged in the domestic corporate bond market come, was due in 2020.

Finally, a stronger renminbi should help the currency's internationalisation, as holders of renminbi assets will be rewarded. For the partner countries in Asia as well as Belt and Road countries this means a sharper choice between following the dollar or the renminbi. ●

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Thomas Kielinger
Die Welt


Denis MacShane
Avisa Partners


Kishore Mahbubani
National University of Singapore


David Owen
House of Lords


Vicky Pryce
Centre for Economics & Business Research


Brian Reading
independent economist


Robert Skidelsky
House of Lords


Michael Stürmer
WELT-Gruppe


Christopher Tugendhat
House of Lords


John West
Asian Century Institute

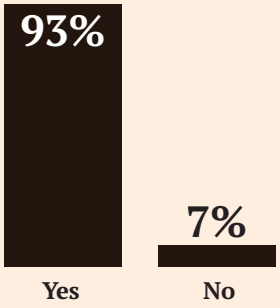

William White
OECD


Juliusz Jabłecki
Nardowy Bank Polski

Ensuring policy harmony

In a speech to OMFIF in November, Bundesbank President Jens Weidmann stated that central bankers need 'to make it very clear that we are not going to place monetary policy at the service of fiscal policy', cautioning that 'if we create a different impression, we are putting both our independence and our credibility at risk.' Do you agree?

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



Talk of monetary policy at the service of fiscal policy is misguided. Both are at the service of the economy. The real challenge for central banks and finance ministries at a time of great financial strain is to work together to ensure that monetary and fiscal policy are in harmony.

John Nugee, formerly Bank of England

No, I do not agree. Extraordinary circumstances call for extraordinary measures, and every central bank needs to work in tandem with fiscal authorities to ensure that the macroeconomic policy response to the current pandemic-driven crisis is as effective as possible.

Jeffry Frieden, Harvard University

Recent history has shown that monetary policy cannot respond to crises alone. Prompt and credible action by central banks has been crucial to stabilising markets, but fiscal policy has been slower to respond.

Irena Asmundson, State of California Department of Finance

In the wake of Covid-19, large scale government bond purchases by central banks and elevated debt have blurred the line between monetary and fiscal policy. Authorities in Mauritius have even amended legislation to allow the central bank to make an outright grant to the government. Such policies, conducted under the pretext of Covid-19, only undermine the independence of central banks and increase the risk of fiscal dominance.

Hemraz Jankee, formerly Bank of Mauritius

Jens Weidmann correctly frames the issue. As central banks increasingly engage in quasifiscal operations and their balance sheets grow, it is inevitable that they will be subject to more scrutiny and criticism, particularly in a populist age. The growing criticism of technology giants by US politicians of both parties is a powerful example of how sentiment can change. To maximise the prospects of sustained independence, central banks should focus on traditional monetary policy objectives and crisis prevention through prudential regulation.

Irena Asmundson, State of California Department of Finance

The future of central banks will depend on the success they have in being seen as far-sighted thinkers and policy-makers. They should avoid insisting on independence for its own sake. Central banks cannot act independently of government in a time of crisis where the roles of it and the finance ministry are intertwined. They should demonstrate their commitment to the long term, especially the shift toward green. Climate change impacts all the variables on which delivery of their exiting mandates rely.

Andrew Large, formerly Bank of England