The Bulletin

Spring 2021
Vol.12 Ed.2

Breaking up is hard to do

How can central banks exit QE?

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Spring 2021 Vol.12 Ed.2

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Cover illustration: Ellie Foreman-Peck @elliefp

Forthcoming OMFIF meetings

DMI Symposium: Central banks and digital currencies – a revolution in money
Wednesday 28 April – Thursday 29 April
A two-day event, featuring keynotes and panel discussions, on the balance of private and public money, cross-border and domestic interoperability, and trade-offs between privacy and transparency.

Taking stock: ECB strategy review and monetary policy challenges
Wednesday 5 May, Virtual
A conversation with Philip Lane, chief economist and member of the executive board of the European Central Bank. He will discuss the status of the ECB's monetary policy strategy review.

In conversation with Olaf Sleijpen: quantifying the risk of climate change to financial stability
Wednesday 5 May, Virtual
A roundtable discussion with Olaf Sleijpen, division director of supervision policy at De Nederlandsche Bank. He will examine the work that DNB has conducted on establishing standard metrics to quantify climate risk.

In conversation with Zhongxia Jin
Monday 10 May, Virtual
A conversation with Zhongxia Jin, executive director for China at the International Monetary Fund. He will discuss the role of China on the global economic and financial stage, multilateralism in the post-Covid world and the climate change agenda.

In conversation with James Bullard
Wednesday 19 May, Virtual
James Bullard, president and chief executive officer of the Federal Reserve Bank of St Louis, will join David Marsh, chairman of OMFIF, for a virtual discussion on the Fed's policies, an outlook for the US economy and global consequences of the pandemic.

The future of sovereign debt management
Tuesday 8 June, Virtual
A high-level, half-day event that will cover the future of sovereign debt and promote idea sharing and best practice in the industry. Topics include the immediate challenges of the Covid-19 recovery, how we can promote a return to normality and the future of markets.

omfif.org/meetings

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

Analysis

OMFIF Analysis includes commentaries, charts, reports, summaries of meetings and The Bulletin. Contributors include in-house experts, advisers network members and representatives of member institutions and academic and official bodies. To submit an article for consideration contact the editorial team at analysis@omfif.org

Meetings

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

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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.

Official Monetary and Financial Institutions Forum
6-9 Snow Hill, London, EC1A 2AY, United Kingdom
T: +44 (0)20 700 27898 E: enquiries@omfif.org
www.omfif.org @OMFIF

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Long Covid

Fifteen months after Covid-19 first took root in the global conscience, some countries are (perhaps prematurely) starting to consider exit strategies for their economies and societies. Central banks face arguably the most daunting task of all in managing the long-term effects of the pandemic.

Breaking out of the cycle of quantitative easing will be hellishly difficult. Clearly unprecedented levels of QE were inevitable given the shutdown of many economies. But have central banks made decisions – many of them before the onset of Covid – that today leave them stuck between a rock and a hard place?

In this quarter's Bulletin cover story, former International Monetary Fund deputy director Tamim Bayoumi makes a compelling case that they have done so (page 10). Central banks have focused their enormous firepower on buying bonds, for good reason. But there is a risk now, as Bayoumi explains, that the 'policy becomes never-ending, with periods of gradual reduction being interrupted by buying sprees'. Bayoumi argues that central banks must be more transparent about their QE exit strategies and that it remains an emergency measure. He goes further and suggests that if there is another economic shock, they should buy equities rather than bonds – taking a leaf out of the Hong Kong Monetary Authority's successful policy during the 1997 Asian financial crisis.

But buying equities has its own drawbacks, as Jesper Koll of Wisdom Tree writes (page 13). The Bank of Japan today owns about 10% of Tokyo's benchmark equity index. This is stifling any hope of a market-led recovery.

Could debt cancellation be another route to exiting QE? OMFIF's Chris Papadopoullos looks at how central banks' reserves systems are increasingly putting their independence at risk and examines how they can escape fiscal policy and debt management traps (page 16).

Meanwhile, Joe Biden's first 100 days as US president have reinvigorated finance's efforts to combat climate change. Contributing editor Philip Moore rounds up the views of leading issuers, investors and policy-makers from an OMFIF/DZ Bank event that spanned 10 hours and three time zones (page 22).

Clive Horwood
Managing Editor
OMFIF

» 13 January

The Boston Fed's CBDC project

IN AUGUST 2020, the Federal Reserve Bank of Boston, in collaboration with MIT, announced that it would research and test leading technologies to determine design requirements for a US-based central bank digital currency. Jim Cunha, senior vice president, secure payments and fintech, Federal Reserve Bank of Boston, discussed this initiative as well as the wider impact of distributed ledger technology on the financial system.

» 21 January

Chinese monetary policy

WHILE THE global economy is far from stabilising amid the pandemic, China's economic recovery stands. As the renminbi appreciates, Mark Sobel, OMFIF's US Chairman, and Kai Guo, deputy director-general of the People's Bank of China, discussed the Chinese central bank's capability in maintaining domestic market stability over the last year.

» 21 January

Germany's political landscape

LUDGER SCHUKNECHT, deputy secretary-general, Organisation of Economic Co-operation and Development, joined Nathan Sheets, chief economist and head of global macroeconomic research, PGIM, to discuss Germany's future political direction and its relationship with Europe, the US and China.

» 11 February

Diem aims to be the digital currency bridge

ON 11 FEBRUARY, an OMFIF audience got to hear first-hand Diem's plans to become a digital bridge between traditional banking and new digital assets. Christian Catalini, chief economist at the Diem Association and co-creator of Diem, tackled head on many of the concerns surrounding the project, presenting it as a tightly regulated organisation that would also incorporate the best facets and outcomes of new digital currencies.

Diem had already made the transition to having at least one-to-one reserve backing focused on single currency stablecoins and had abandoned permission-less systems. Catalini went further at the OMFIF meeting, detailing how Diem will not allow the digital currency to be fractionalised or leveraged elsewhere. That will include requiring other wallet providers to ensure liabilities are backed one-to-one.

In his discussion with OMFIF's Digital Monetary Institute, Catalini also gave new insights into the regulatory process that Diem has submitted to. Diem's payment licence application is essentially treated as a new bank by its regulator, the Swiss Financial Market Supervisory Authority (FINMA), Catalini said. The Diem reserve closely follows Basel III's capital requirements and incorporates additional buffers to account for redemptions. Catalini stressed that Diem's regulatory approach was a crucial differentiator to other cryptocurrencies, and 'breaks new ground by bringing some of these best practises into the digital assets space.'

During an engaging Q&A session, attendees raised concerns about Diem's impact on currency substitution, particularly for emerging markets. According to Catalini, Diem's long-term goal for these countries is 'to work with the public sector to enable more single currency stablecoins' denominated in their local currency. For this solution to work, Diem would still need large pools of these assets that are liquid enough and of high quality, an aspect that has not yet been fully addressed.

Diem's aspiration to reach unbanked populations is severely restricted by the lack of formal identity or address, reliable network infrastructures, digital literacy, and access to mobile phones in many countries. These remain prerequisites that need to be solved, Catalini said.

Katie-Ann Wilson, programmes manager, fintech and emerging markets

» 8 February

Euro area stability: a view from the IMF

PHILIP GERSON, deputy director of the International Monetary Fund's European department, discussed the effects of the pandemic on the euro area economy, setting out key findings from the IMF's report '2020 consultation on common euro area policies', published in December.

» 15 February

Monetary policy in Eastern Europe

DEPUTY GOVERNORS from the Czech, Hungarian and Polish central banks discussed the respective measures they have taken to curb the reduction in gross domestic product during the Covid-19 crisis. They also set out their monetary policy decisions and next steps for a sustainable recovery.

» 17 February

Steps towards an effective economic recovery

PIER CARLO PADOAN, chairman designate of UniCredit and former Italian finance minister, discussed the structural challenges in fostering a post-pandemic economic recovery across the euro area, highlighting the role that the banking system can play.

» February 24

AIIB's Jin extends olive branch to Biden team

JIN LIQUN – a veteran economic official who has been Asian Infrastructure Investment Bank president since its inception in 2016 – revealed early informal contacts with 'our friends' in President Joe Biden's team, signalling an international co-operation agenda on finance and development.

In a wide-ranging OMFIF conversation on 24 February, Jin outlined energetic plans for the AIIB's growth, including stepped-up public-private partnerships in Asia and beyond to help speed recovery from the pandemic-driven downturn.

Jin highlighted the aims of lean, effective AIIB governance, a war on 'institutional obesity' and a genuinely international corporate culture not dominated by China. He emphasised the importance of climate mitigation across the bank's $23bn of loan projects, including a ban on coal-related lending and an intensified commitment to renewable energy across Asia and other continents.

Heralding reduced state funding influence and a widening range of infrastructure finance, the bank plans to boost the private sector share of financing to 50% by 2030 and will increase investment in areas like healthcare and digital technology. Healthcare is the weakest link in the global economy, Jin said. 'A healthy nation is a productive nation.'

Asked about the prospect for a new spirit of multilateralism with the US, in spite of problems over trade, technology, military rivalry and human rights, Jin said: 'I have a lot of friends who are either Democrats or Republicans. We also have Americans who serve on our international advisory panel. We have very senior people in finance or risk management. They are reaching out to the [Biden] officials in an informal way, so we hope we can make our bank better understood by the new administration.'

Jin insisted the AIIB's track record was its best tool for gaining credibility. 'Trust has to be earned... You cannot talk people intro trusting you.' He pointed out that US and Japanese citizens held positions at the AIIB, including at the 'nerve centre' of the bank in the president's office. 'They have access to all information...We are in the global interest. There is nothing to hide.'

David Marsh, chairman, OMFIF

'Trust has to be earned... You cannot talk people into trusting you'

» 1 March

The UK's future trading relationships

AS THE UK negotiates new trade relationships across the globe, Ranil Jayawardena, minister for international trade at the UK Department for International Trade, discussed the country's priorities. He outlines the most important future relationships and how they are developing, as well as the opportunities for domestic and foreign businesses working in the UK.

» 11 March

Market developments in Central America

OMFIF CONVENED panellists from the Japanese Foreign Ministry, BBVA, Cabei and IFC to discuss the macroeconomic outlook of Central America. They debated Central America as an attractive destination for foreign investment and commerce as the Asia Pacific region begins to consider post-pandemic opportunities.

» 18 March

Stability in the face of social networks

OMFIF and the CME Group brought together a panel of experts, including regulators from Hong Kong and Thailand, to consider how technology has opened up the markets to new participants and discuss mechanisms to balance the interests of society and economy.

» 4 March

Koopman lays out NextGen EU issuance agenda

THE CREATION of an agency which in many ways looks like a European version of the US Treasury raises some intriguing questions. And Gert-Jan Koopman, director-general for the EU budget at the European Commission, answered them at a one-day discussion on sustainable finance co-hosted by OMFIF and DZ Bank.

Next Generation EU, the €750bn recovery fund designed to help repair the immediate damage caused by the Covid-19 pandemic, expects to launch its maiden bond in June, after which it will remain a regular issuer until 2026.

It could help transform bond markets in Europe and beyond, given the fund's long-term environmental, political and macroeconomic targets. Koopman acknowledged that as well as acting as an essential funding instrument, a successful Next Generation programme would help to 'build and strengthen the ESG capital market.'

Additionally, said Koopman, it will 'bolster the international role of the euro and demonstrate the cohesiveness and robustness of the euro area.'

These are no small tasks, and Koopman fleshed out details of how the new borrower would achieve them. 'Given the volumes, frequency and complexity of the fund's borrowing, the Commission is putting forward a debt management policy on a par with that of some of the most advanced EU sovereign borrowers,' he said.

Koopman explained that this will mean issuing across the entire yield curve, from short-dated bills to long-dated benchmarks with maturities of up to 30 years. This will call for funding via auctions as well as syndications.

Next Generation EU will be borrowing as much as €160bn in each of the next five years. Of this total, 30% will be in green bond format. 'It is only natural that our funding mix reflects the green and social model which is in the DNA of the EU's policy-making,' said Koopman.

Siegfried Ruhl, head of funding and investor relations at the European Stability Mechanism, added: 'The bill programme will hopefully make the euro more attractive as a reserve currency.'

Philip Moore, freelance financial journalist

» 6 April

Roadmapping the transition from Libor

THE LONDON Interbank Offer Rate will cease to be in effect from 31 December 2021. Financial institutions that use LIBOR must prepare to protect their businesses from any financial shocks as they transition to alternative reference rates. Ann Battle, head of benchmark reform at ISDA, discussed the landscape post-LIBOR and the potential roadmap for avoiding disruption.

» 12 April

Euro area recovery and ECB response

AS THE RECOVERY phase of the pandemic plays out, the ECB has a role alongside fiscal efforts to ensure a sustainable path back to growth in the euro area. Massimo Rostagno, director, directorate general monetary policy at the European Central Bank, discussed the ECB's monetary policy toolkit and response to Covid-19.

» 20 April

German constitutional court update

BERND LÜCKE, leader of the group bringing the latest constitutional court case on the recovery fund in Germany, and Hans-Olaf Henkel, former member of the European Parliament, discussed the progress of this case and how it fits into wider German and European frameworks.

» 24 March

France backs looser EU debt rules

The EU will need to revise its Stability and Growth Pact to support the currency bloc's economic recovery, Emmanuel Moulin, director general at the French Treasury, told an OMFIF roundtable on 24 March. He added that the planned €750bn of common bond issuance, which will include a green element, is an important step towards increasing the international role of the euro.

France spent €87bn or 4% of gross domestic product in 2020 on its emergency response, on top of providing €326bn of guarantees and €90bn of loans. Its €100bn recovery plan has €30bn earmarked for greening the economy, €34bn to enhance competitiveness and €36bn for employment and training initiatives. Echoing Mario Draghi, Italian prime minister and former European Central Bank president, Moulin said Europe is ready to do 'not whatever it takes, but whatever it costs'.

Providing the fiscal support needed to fuel the European recovery will require changes to the Stability and Growth Pact, which would otherwise require countries such as France, Italy and Spain to reduce their debt to GDP ratio by around two to three percentage points per year. 'We need to rethink this as well as indicators such as debt-to-GDP in an environment of low interest rates,' Moulin said.

'Up to now we are all on the same page, and we should continue with a supportive fiscal stance until we are out of crisis. No one can consider that they are currently out of the woods – the situation may get worse before it gets better.'

The euro area's common bond issuance, which will go toward funding its €750bn Next Generation EU recovery plan, is an opportunity to build a European safe asset, Moulin highlighted.

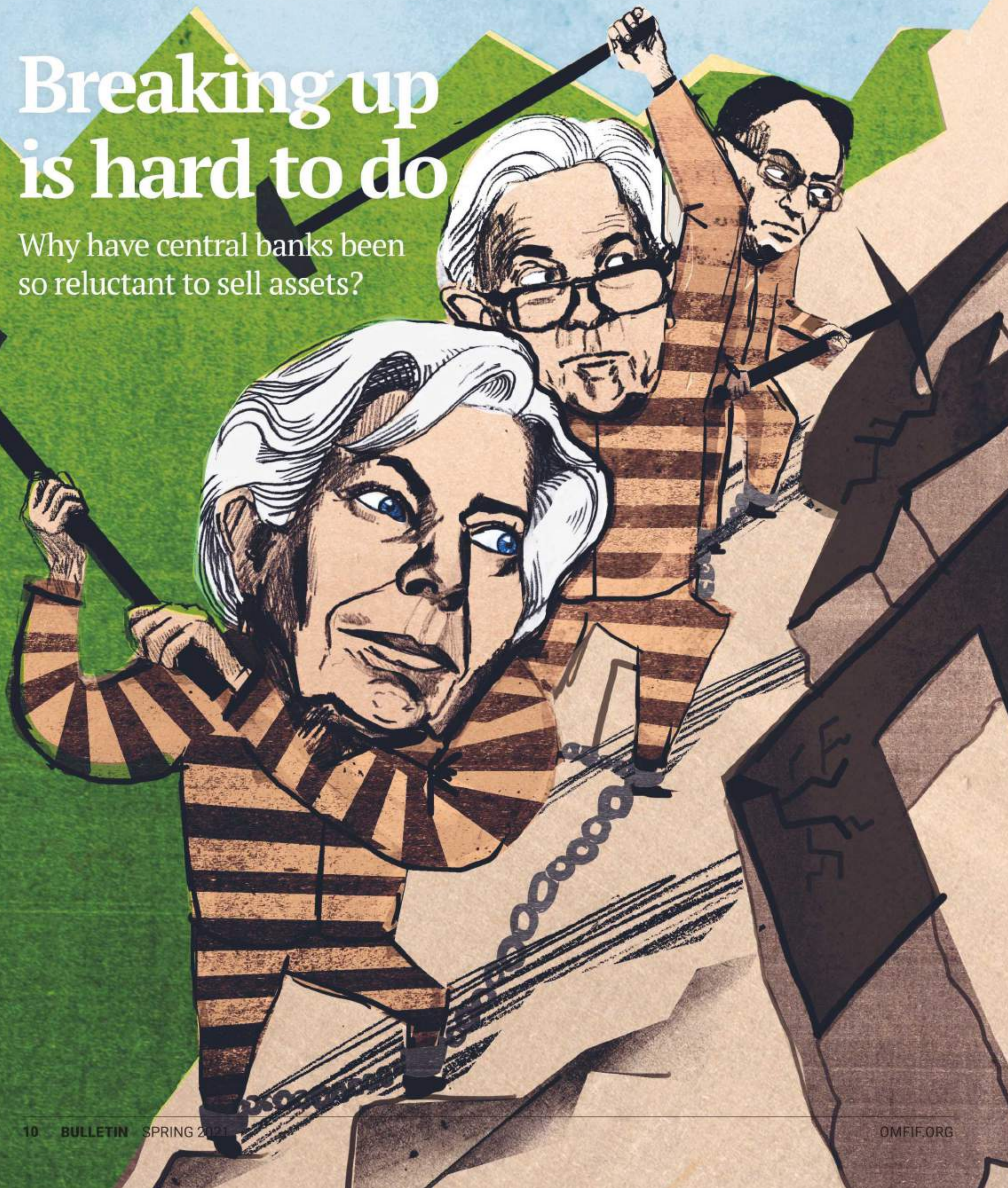
'We view this as both a political and financial instrument, we have never shied away from the fact that we think it's important that the EU has a significant role on the international markets, we've been advocating the international role of the euro,' Moulin said.

'We are creating a new framework which we think has both political consequences but financial consequences for the international role of the euro that can create a new asset and attract international investors.'

Chris Papadopoullos, economist at OMFIF

Breaking up is hard to do

Why have central banks been so reluctant to sell assets?



Tamim Bayoumi
formerly International Monetary Fund

Quantitative easing has been deployed by all major advanced countries' central banks in response to the constraints on cutting policy rates caused by the zero lower bound. The difficulty is not in buying bonds and providing economic stimulus, but comes in selling bonds. Indeed, no major central bank has sold any of the bonds that they have bought. The exit strategy from QE remains unclear.

Major QE programmes were kicked off in 2009 by the Federal Reserve and the Bank of England as an emergency reaction to the 2008 financial crisis, followed by others in Japan and Europe. The programmes obviously reflected the economic and institutional features of each economy.

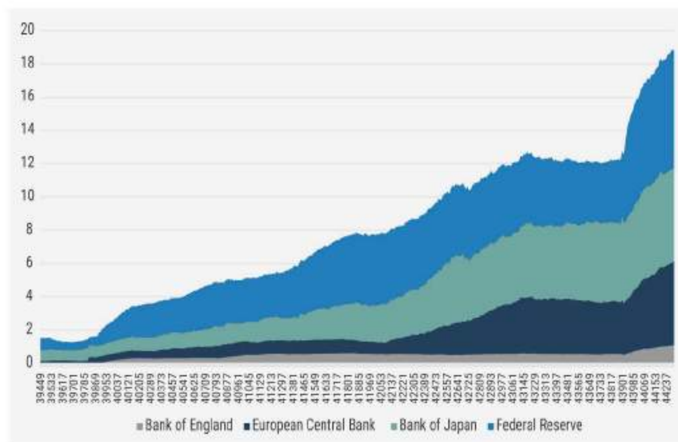
However, the trend of bond holdings have been surprisingly consistent across countries. They have tended to expand rapidly, before stabilising at a higher nominal value as central banks reinvest principal payments into new purchases. The only case where nominal bond holdings reduced involved the Fed, which in early 2018 started reinvesting only part of principal payments. This policy ended in 2019 though, with bond holdings still around four times their pre-2008 value.

This reluctance to sell has meant that nominal holdings have risen over time as new shocks have justified more stimulus. Indeed, because of Covid-19, major central banks are buying more bonds.

Why have the banks been so reluctant to sell? Central banks embarked on QE to stimulate the economy. While several mechanisms were envisaged, including signaling a commitment to loose monetary policy, the main long-term benefit was seen as coming from the impact on the supply of bonds to the private sector. When central banks bought government bonds, this lowered the amount available to other investors, raising the price and lowering the long-term interest rate. There were also knock-on effects on other asset prices, such as equities. Borrowing became cheaper, making such assets more attractive.

Numerous studies found that QE stimulated the economy. One survey concluded that announcing a plan to buy bonds worth 10 percentage point of gross domestic product was equivalent to lowering the policy rate by 0.5%.

But if buying bonds stimulates the economy, then selling bonds will reverse the process and deflate it. When central banks sell bonds, prices fall and rates rise. This may seem like normal monetary tightening using interest rates.



1. Central bank asset purchases have boomed

Securities held outright, $tn

Source: OMFIF Central Bank Policy Tracker

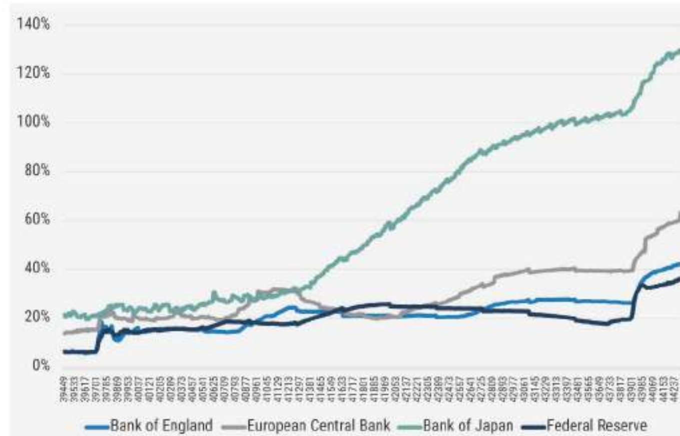
However, in the case of bond holdings there is a catch. If the price at which central banks sell bonds is lower than the price they bought them at, they will bear a capital loss. Given the size of the portfolio, such losses could be notable, as work by the Bank of England has illustrated. These potential losses are a concern for several reasons, including because it could undermine central bank independence.

One way around this is for central banks to hold their bonds to redemption. If they do this, assuming the interest rate is positive, they will never face the risk of losses. The difficulty with this strategy is that it takes time. Even if central banks were to take a passive approach and allow all their bonds to expire, it would take nearly a decade to exit QE. And, as has been demonstrated since 2008, the economy will likely encounter new shocks that require new bond purchases. There is a risk that the policy becomes never-ending, with periods of gradual reduction being interrupted by buying sprees.

The problem is that the price of safe assets tends to be high in recessions and low in recoveries. Bonds have major disadvantages for a programme such as QE. The better approach would have been to emulate the Hong Kong Monetary Authority during the Asia crisis. The HKMA bought 'risky' equities rather than 'safe' bonds. The advantage is that equities are cheap in a recession and rise in value during a recovery. Indeed, the HKMA was able to sell its equity holdings quickly after the crisis and at a profit.

The Fed illustrated the difficulties around selling bonds. In 2011, the Federal Open Markets Committee stated that, when appropriate, it would 'cease reinvesting some or all payments of principal on the securities holdings'. This would be followed by increases in the federal funds rate and sales of securities. This would bring securities back to 'the smallest levels that would be consistent with the efficient implementation of monetary policy' in three to five years.

However, the guidance became more circumspect after 2013's taper tantrum. In 2014, the Committee announced that the



2. Asset purchases have changed central banks' role in major economies

Ratio of total assets to GDP

OMFIF Central Bank Policy Tracker

balance sheet reduction should come after it started to increase the federal funds rate and that it 'did not anticipate' outright sales of securities. Instead, it planned to 'reduce the Federal Reserve's securities holdings in a gradual and predictable manner primarily by ceasing to reinvest repayments of principal'.

This is what the Fed did. It reinvested only a part of principal payments, although it never ceased all reinvestments. Subsequently, in March 2019, the FOMC decided to exit this policy of balance sheet reduction at the end of September 2019, while still holding $3.5tn in securities (holdings were some $800bn before QE).

Are large central bank holdings of bonds a significant issue? After all, the Fed has consistently stated that interest rates would be the primary monetary policy instrument. So why not continue to hold large amounts of bonds?

Being a bondholder creates complications for central banks. First, as with the taper tantrum, markets respond to balance sheet and exit policies. Second, holding large amounts of securities leaves central banks open to accusations that they are artificially supporting wealthy financial institutions or helping finance irresponsible government borrowing. Third, central banks may be tempted to provide preferential support for particular companies (there is an active debate in Europe about whether to use QE to assist green companies). Importantly, this may move central banks away from technical decisions and closer to political policies that are typically carried out by elected officials, eroding arguments for independence.

Greater transparency about exiting QE is needed. Central banks should make it clear that QE was, and remains, an emergency measure. They must discuss the criteria they will use to decide when and how to lower bond holdings. The easiest exit strategy is to take a passive approach and not reinvest principal payments. If, however, this implies a bumpy path for bond holdings, there may be some justification in using principal payments to buy short-term bonds. The aim should be to lower bond holdings to a level that stabilises market volatility without being so large as to provide significant economic support.

Most importantly, if there is another economic shock, central banks should consider buying equities rather than bonds. This has many advantages. Because equity prices fall over a crisis, the same support to the economy can be achieved at a much lower cost. Also, as the HKMA showed, exiting the strategy is easier. Indeed, had central banks followed this approach, they would have already exited their initial interventions before the Covid-19 pandemic created a new shock that required more purchases. ●

Tamim Bayoumi is former Deputy Director of the International Monetary Fund's strategy, policy, and review department.

How Japan can escape financial socialism

Encouraging retail investors to buy the BoJ's stock of ETFs

Jesper Koll
WisdomTree

The latest Bank of Japan comprehensive policy review is significant not for what it says but what it doesn't. The cumulative effects of the central bank's steadfast buying of exchange-traded funds have de facto turned Japanese equity markets into an unprecedented experiment in financial socialism. Officials seem to have no idea how to restore the functioning of free markets.

Like many central banks, the BoJ has aggressively intervened in bond markets and now owns almost half of its country's public debt. Unlike others, the BoJ also now owns about 10% of Japan's benchmark Tokyo Stock Price Index (TOPIx) equity capitalisation. This casts a shadow over Japan's markets. The first question investors usually ask me is, 'When will the BoJ start to sell?'

There is no question that Governor Haruhiko Kuroda's firm commitment to buying Japanese equities was an important catalyst for stopping asset deflation and building confidence in Japanese stocks. But now, almost a decade later and with the market up almost threefold from its bottom, the BoJ's equity holdings are beginning to work as a cap on the market's upside potential. Unwinding a bond portfolio is easy: you can wait until they mature and roll off the balance sheet. In contrast, equity ETFs will have to be sold sooner or later.

Moreover, the ETF policy is counterproductive to at least two other major policy goals: improving corporate governance and private investors' capital stewardship and promoting an innovative financial centre in Tokyo. In capitalism, ownership is key. Although the bank holds 'only' 10% of the TOPIx, it now owns more than one-third of the free-float in many of Japan's leading companies, including Japanese global large cap stars like Fast Retailing or robot manufacturer FANUC.

The BoJ's stakes are huge, but they are mute; it will never raise its voice at annual shareholder meetings. Technically, this could be changed if the BoJ instructed its ETF custodian banks to vote in line with governance activist groups like Institutional Shareholders Services. However, this immediately adds a new dimension to the moral hazard problem and risks the BoJ being accused of reincarnating the old Japan Industrial Bank which directly elected and pressured private executives.

As for innovation, while the BoJ's yield curve control actually forces Japanese banks to invest and develop new profit centres that do not rely on traditional net-interest margins (although they complain about this to no end), the BoJ's ETF buying has made Japanese asset managers lazy. The fact that the three largest asset managers appear to be making as much as two-thirds of their profits from their cut of the 32 basis points fee the central bank pays for its ETF holdings suggests they are gorging at the BoJ's trough.

> 'The BoJ's stakes are huge, but they are mute; it will never raise its voice at annual shareholder meetings.'

There is no sign of new innovative retail products being developed – no 'smart beta', no 'factor funds' or thematic ETFs being created. Most importantly, they have had no incentive to develop lower-cost options for retail investors, who still pay around double the fees for investment funds compared to US peers. The BoJ's ETF programme is one reason for the sleepiness of Japanese asset managers, but there can be little doubt that the bank's generosity has been a disincentive to product innovation in the retail investor space.

All said, the BoJ's extraordinary ETF buying programme was clearly justifiable as an emergency effort to stop an asset deflation downward spiral. The central bank's de facto nationalisation of equity capital markets has become counterproductive for many reasons. The biggest is that nobody can conceive a smooth exit – if the BoJ starts selling, the market will surely crash.

Who could buy the BoJ equity overhang and prevent such a sudden correction? There is only one answer — Japanese savers in general, and the older generation in particular (over 65-year-olds own more than 70% of household net financial assets.) To get an elderly saver to swap from bank deposits into risky ETFs will require a real incentive.

The answer lies in inheritance tax, which is extraordinarily high at up to 55%. If the BoJ and the Finance Ministry can co-operate and devise a scheme where any individual who buys ETFs directly from the BoJ will have these ETFs exempt from inheritance tax, the central bank could clean up its balance sheet within a couple of weeks. The net result would be the reprivatisation of Japanese equities, a healthier corporate ownership profile and a better risk return profile for household sector balance sheets.

Ending Japan's unique experiment in financial socialism and restoring free market functioning will require unprecedented co-operation between monetary and fiscal authorities. But make no mistake: without some sort of guidance from Governor Kuroda and his team at the BoJ, domestic and global investors will continue to demand a discount for holding Japanese equities. ●

Jesper Koll is Senior Adviser to WisdomTree in Tokyo.

Watch what central banks do next

Should we be concerned about higher inflation after the pandemic?

Mojmír Hampl
KPMG

Central banks, their independence and their price stability mandates are the alpha and omega when it comes to answering the frequently asked question of whether we should be concerned about higher inflation after the pandemic. Central banks are helping the situation by correctly pursuing accommodative monetary policy. What they do next is vital for the global economy as it recovers from Covid-19.

Will central banks become an extended arm of over-indebted governments, leading to higher inflation? Or will they unflinchingly fight any excessive inflationary pressures like they have fought recent deflationary ones?

Fears of inflation have been misplaced in the past. After the 2008 financial crisis, central banks used unconventional policies such as quantitative easing, zero or negative interest rates and foreign exchange interventions to bring down real interest rates and prevent deflation. This was because they were facing low demand and underused capacity, or a 'negative output gap', which was pushing prices down, not up.

By fuelling the monetary system, central banks were merely trying to make sure that commercial banks generated enough steam so the economy didn't stop. The media cliché of money printing was imprecise and misleading.

The situation now is not entirely the same as it was after the 2008 recession. The US can be seen as a proxy for what is going to happen sooner or later in many developed countries.

The total money stock may be rising faster, but the velocity of money is falling. Although we long ago stopped believing in the monetarist direct link between money and inflation, that link is inflation-neutral in the current situation anyway. If, due to an inability or unwillingness to buy, the larger quantity of money in the system is not being spent, there will be no effective demand and hence no inflation.

Many governments are now taking an active fiscal approach, running up huge debts in the process. Government debt to gross domestic product ratios in the developed world are hitting levels last seen during the second world war. This is fine so long as governments are only providing compensation for the impact of the pandemic. However, some of the fiscal programmes (such as President Joe Biden's $1.9tn American Rescue Plan) seem extravagant even to moderate mainstream economists. There is a danger that governments will not only overcompensate for the shortfall in demand, but directly overheat the economy and generate inflation pressures.

In a key paper, veteran of the economic community Charles Goodhart and his colleague Manoj Pradhan offered a profound structural argument for being concerned about inflation. They posit that the great moderation era of anti-inflationary and deflationary pressures is over. The supply of cheap labour in Asia and Eastern Europe is drying up and cannot be renewed. On top of that, in the developed world the pandemic has strengthened the tendency towards localisation – the desire to bring production back home for reasons of security and resilience (however illusory that might be), and towards systemically more costly labour. Goodhart and Pradhan released a new book on this subject last year.

By contrast, the natural rate of interest – the interest rate consistent with stable inflation and economic equilibrium – is not rising in the developed world. This would suggest that the long-running downward pressure on inflation and interest rates is not over.

Pandemics tend to be followed by a period of 'consumer euphoria', which drives prices upwards. And consumer price indices have underestimated the true level of inflation for much of the pandemic. With many services unavailable and shops shut, people have been spending far more on basic foodstuffs – prices of which have been rising faster – and far less on clothing and footwear. The fixed weights of the CPI basket have been unable to take this into account. The International Monetary Fund has made a quantitative estimate of this effect for the regions of the world.

> 'There is a danger that governments will not only overcompensate for the shortfall in demand, but directly overheat the economy and generate inflation pressures.'

So the question is whether the idea of 'average inflation' targeting, presented by the Fed at the 2020 Jackson Hole symposium, or the idea of redefining the objectives and mission of the European Central Bank (both of which might lead towards tolerating higher inflation) are coming at the right moment for the general public. There were more suitable times for central banks to consider tolerating higher inflation for good reasons, but not now.

To keep their credibility, and given the uncertainty, perhaps it is enough for central banks to stick with their current goals rather than start fiddling with incomprehensible redefinitions. ●

Mojmír Hampl is Head of Financial Sector Services, KPMG Czech Republic, and former Vice Governor of the Czech National Bank.

Central banks beyond the pandemic

A new consensus is set to emerge

Katharine Neiss
PGIM Fixed Income

When the Federal Reserve launched its framework review in early 2019, there were concerns that limited policy space was restricting monetary policy-makers' ability to return inflation to target given low real interest rates. By that summer, the Fed had concluded that quantitative easing and forward guidance had been effective responses to the 2008 financial crisis. Moreover, associated costs had been lower than initially feared. The Federal Open Markets Committee could proceed 'more confidently and pre-emptively in using these tools in the future if economic circumstances warranted'.

The timeliness and importance of this insight for the pandemic response cannot be overstated. Within days of each other in mid-March of last year, the Fed, European Central Bank and Bank of England announced aggressive quantitative easing that averaged more than 5% of respective gross domestic products. Market dislocation was immediately calmed, economic activity recovered faster than anticipated and inflation started to recover. Though a full assessment is still years away, it is difficult to argue that timely, aggressive quantitative easing and the commitment to stay the course has been anything but successful.

There is little consensus, however, on what next for central bank balance sheets. Mindful of the taper tantrum of 2013, when markets overreacted to a gradual slowing in the pace of future asset purchases, the FOMC is now at pains to communicate that tapering discussions are currently off the table, despite the positive economic outlook in the US.

The ECB's temporary pandemic emergency purchase programme allows flexible purchases, sidestepping the need for tapering announcements. However, meeting the ECB's inflation target will require a significant increase in open-ended asset purchases just as the PEPP unwinds. Any hiccups around engineering a smooth and orderly transition could threaten a European version of snap back risk.

Lastly, Bank of England Governor Andrew Bailey has suggested that central banks may want to shrink their balance sheets before raising rates, in contrast to the prevailing view that rate rises should predate unwinding of asset purchases. The argument is that balance sheets are a useful tool which can be expanded when markets are dislocated, and so need to be contracted when market functioning has been restored to replenish the toolkit.

While it was incredibly lucky to have consensus around the appropriate monetary policy response as the pandemic unfolded, a new policy challenge lies ahead. In the longer term, a new consensus is likely to emerge around a few key points: the importance of clear central bank communications and early signalling of balance sheet tapering, the need to commit to policy easing until the post-pandemic economy achieves 'escape velocity' and inflation has returned to target, and the reality that central bank balance sheets will remain permanently larger. ●

Katharine Neiss is Chief European Economist at PGIM Fixed Income.

'While it was incredibly lucky to have consensus around the appropriate monetary policy response as the pandemic unfolded, a new policy challenge lies ahead.'

Reserves system puts independence at risk

Central banks need to escape fiscal policy and debt management trap

Chris Papadopoullos
OMFIF

As national debts expand, calls from economists for debt held by central banks to be cancelled grow louder. For European Central Bank President Christine Lagarde, the idea is a non-starter.

'Article 123 of the Treaty on the Functioning of the European Union forbids the ECB from financing the budgets of member states, pure and simple. Debt cancellation would be exactly that. Breaking European treaties is not on my road map,' she told French newspaper Le Monde in October last year.

The same newspaper had published a letter from 100 economists calling for the cancellation or replacement of bonds held by the ECB with perpetual, zero-interest bonds. 'The real question is whether the EU is going through such extraordinary times that would in turn call for extraordinary measures. We believe these are extraordinary times,' they said. While cancelling the debt held by the ECB would take an extraordinary effort, its impact on fiscal sustainability would be anything but.

This is because asset purchases programmes do not reduce the liabilities of governments, but swap one liability for another.

Britain, long proud of its extended debt maturity, recently found its debt servicing costs had become significantly more sensitive to changes in short-term interest rates. Bonds taken out of the market by central bank asset purchases had been replaced by bank reserves, which pay interest at the policy rate. If the BoE were to raise rates, debt servicing on a chunk of government liabilities would increase instantly, rather than when gilts were rolled over or new ones issued.

So far as central banks care about government liabilities, their focus is on the level of reserves held by financial institutions. So far as debt management offices care about them, it is on the stock of debt securities. But for debt servicing costs and fiscal sustainability, policy-makers will need to look at the level of reserves at the central bank and stock of bonds outside the central bank.

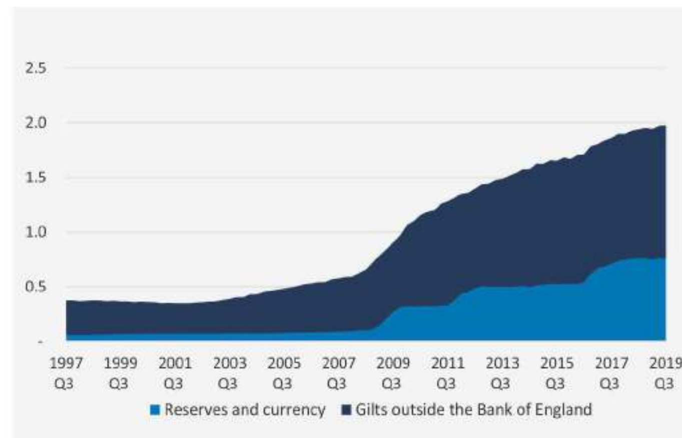
Given that most central banks are owned by their governments, the payment of bond interest, impact of changing valuations and even central bank equity are intergovernmental assets and liabilities. Intergovernmental assets and liabilities are largely formalities and can be changed, cancelled or created without major macroeconomic consequence. It is usually legal issues that get in the way.

Charles Goodhart, doyen of central banking economists and veteran professor at the London School of Economics, told OMFIF that what is needed now is a 'holistic approach to the national debt and reserves held at the central bank', as asset purchases had 'shortened the duration of the national debt'. 'You have to look at the liabilities of the public sector as a whole,' he said.

So, the broader, more important question is how the government should manage its liabilities, in this case reserves at the central bank and gilts not held by the central bank. Debt cancellation is one answer, because it removes the primary method by which central banks would swap reserves back for gilts. The result is that a large slice of liabilities remains bank reserves.

Many advanced-economy central banks have resigned themselves to the fact that the

'Charles Goodhart, doyen of central banking economists, told OMFIF that what is needed now is a "holistic approach to the national debt and reserves held at the central bank".'



1. Bank reserves now a significant UK government liability

Gilts outside the Bank of England and reserves, £tn

Source: Office for National Statistics, OMFIF analysis

> **'To remove the central bank from the equation and avoid questions over independence, it may be necessary to shrink the size of its balance sheet and level of reserves.'**

level of reserves will remain elevated for the foreseeable future. The Federal Reserve calls it the 'ample reserves' system and plans to maintain it.

The problem is that this brings central banks into the fiscal equation in a more direct way and exposes them to politics to an extent that proponents of central bank independence would find troublesome.

To control interest rates in an ample reserves system, the central bank pays interest on reserves. If a central bank lifted interest rates, the maturity mismatch on its inflated balance sheet would require transfers from fiscal authorities. It would not look good politically if finance ministries were making cuts in politically sensitive departments while transferring money to central banks so they can recapitalise and make interest payments to commercial banks.

Whatever central banks do, they have an impact on the fiscal situation. Paying interest on reserves to a bank is not much different to a bank receiving interest on a government debt security. It is more a question of politics.

There are ways to minimise the fiscal cost of interest on reserves. One is to apply policy interest rates to only a portion of reserves, as the ECB currently does with its negative interest rate. The problem then is that in a positive interest rate environment that becomes a tax on banks, which they would likely pass onto depositors given already tight interest margins.

As interest rates rise, interest on bank deposits falls below the rates that can be paid on other financial instruments, such as short-term government debt. The consequences of this would be like that of Regulation Q in the US, which banned the payment of interest on demand deposits. The rule spurred the creation of money market funds, which are now called shadow banks. These allow corporates and high-income households to access higher interest rates than those without access to such financial services.

To remove the central bank from the equation and avoid questions over independence, it may be necessary to shrink the size of its balance sheet and level of reserves. This is straightforward in theory, but a little awkward in practice. Central bank reserves are similar in behaviour to short-term government securities; they pay interest at or near the central bank policy rate, have stable capital value and are favoured by banks for their liquidity. If the central bank were to replace the stock of reserves with bills and short-term bonds, and if there was a facility where commercial banks could swap bills for reserves in an instant, there would be very little impact on the yield curve and macroeconomic situation. It would simply involve banks swapping one very liquid asset for another.

Tweaks to current prudential rules and resolution rules, though not major overhauls, would be needed. This was the idea behind the 'standing repo facility' which Jane Ihrig and David Andolfatto, senior Fed economists, proposed in 2019 before the US money market tantrum later that year.

The facility would allow commercial banks to swap treasuries for reserves, which would reduce their demand for reserves in normal times and allow the Fed to shrink its balance sheet. But here is where monetary policy crosses over with macroprudential policy. Reserves and government bonds are often treated slightly differently by regulators, as are repos and outright transactions.

Andolfatto told OMFIF, in a recently published interview, that 'using a US Treasury as collateral for a loan and buying it outright should not matter much in terms of economic impact, but the borrow versus buy decision can interact in peculiar ways with existing regulations, including capital requirements. So, for example, an outright purchase of securities from broker-dealers may have a more advantageous impact on their balance sheet relative to an equivalent repo transaction.'

He said that reducing the level of reserves in normal times was 'not an economic issue, it's a political one. It makes a difference in terms of the optics.'

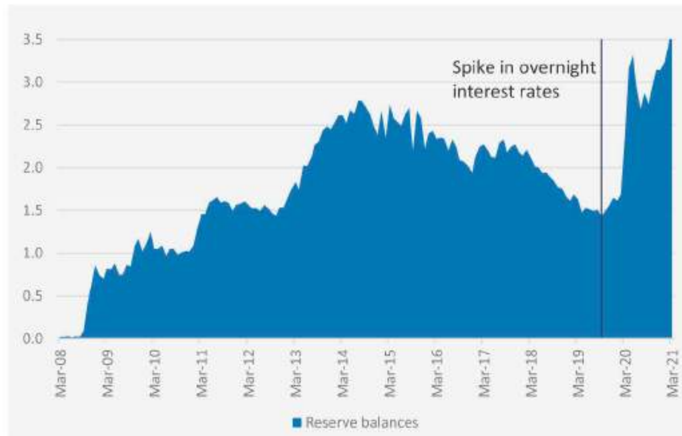
'If we can reduce the Fed's footprint at no economic cost, why not do it? Politically, it could help protect the Fed's independence.'

Under this approach, asset purchases

2. Falling reserves sparked US liquidity crunch

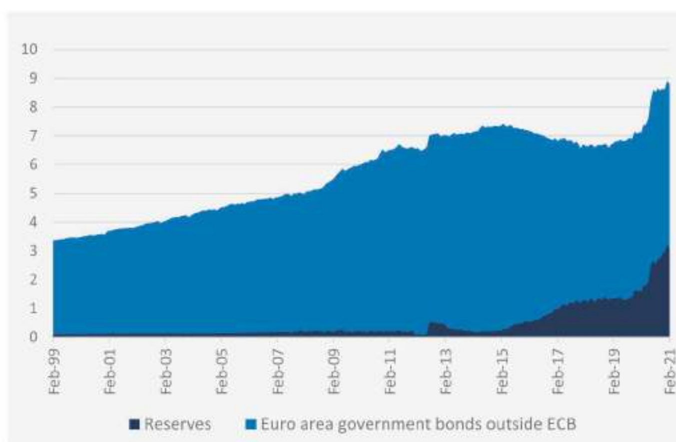
Depository institutions' reserve balances at Federal Reserve, $tn

Source: Federal Reserve, OMFIF analysis



ultimately become debt management exercises, with long bonds taken out of the market and short bonds put in.

This comes back to an idea Goodhart posed in a 2017 paper. He argued that it was necessary for the central bank to conduct asset purchases when there was a liquidity crisis, but that QE in the absence of a liquidity crunch, and when there are already ample reserves, is more like a debt management exercise. Similar results would be achieved by swapping long-dated bonds for short-ones, an operation twist. Goodhart told OMFIF that the best way to engineer a debt-for-reserves swap would be to trade the reserves for tranches of bonds from one to five years in maturity.



3. One third of Euro area government bonds have been swapped for reserves

Reserves at ECB, government bonds outside ECB, €tn

Source: ECB, OMFIF analysis

A common European approach

This is all well and good in single monetary-fiscal areas like the UK and US, but what about the euro area? Writing debt off and maintaining a high level of reserves indefinitely would be difficult treaty-wise, as would replacing the debt with perpetual, zero-interest debt, as the 100 economists suggested. Both would require a broad renegotiation of EU treaties.

'No one wants a grand renegotiation,' Emilios Avgouleas, chair in international banking law and finance at the University of Edinburgh, told OMFIF. Instead, in a paper he co-authored with Stefano Micossi, director of Italian business association Assonime, he suggested bonds held by the ECB are sold to the European Stability Mechanism, with the ESM issuing its own bonds to finance the purchases.

The paper envisages the ESM acquiring them over a 10-year period, but purchases could accelerate if the ECB needs to sell parts of its holdings for monetary policy purposes. This would allow it to unwind policy without causing fiscal crises in countries with high levels of debt. The paper also says that this would fulfil demand for a common euro area asset, as well as end the 'doom loop' between banks and their sovereigns. It is essentially the sort of liability swap described above, but one which navigates the treaties rather than requires changing them.

> 'Britain, long proud of its extended debt maturity, recently found its debt servicing costs had become significantly more sensitive to changes in short-term interest rates.'

The euro area, the authors write, needs a common policy to manage the rollover and recovery risk on sovereign debt. The paper, written for the Centre for European Policy Studies, said: 'This task could not be permanently entrusted to the ECB without crossing the line that separates monetary policy from fiscal policy, as established by the European Court of Justice... The ESM, which is an institution set up by euro area governments as a crisis management tool, and which has enough capital to cover any losses from such operations, looks like the natural choice.

The ESM could then evolve into a common debt manager. A coordinated debt management policy makes sense. The ECB is keen to prevent the yield curve steepening unless it reflects stronger growth expectations for the euro area, which would encourage debt management offices to issue long-dated debt. The more that is issued at the long end, the more the ECB will need to buy to prevent upward pressure on long-term rates. Debt management offices and the ECB are pushing in opposite directions and some coordination would be welcome. Italy's debt management office, for example, introduced a policy of lengthening the maturity of its debt last year and recently issued its first 50-year bond in five years, raising €5bn.

> 'This is all well and good in single monetary-fiscal areas like the UK and US, but what about the euro area?'

Following this policy now would be straightforward, says Avgouleas, and would help take legal pressure off the ECB with regard to constitutional challenges in Germany. To change the ESM into a euro area debt manager would require changes to the ESM treaty and not a 'grand renegotiation' of the kind required to write off debts. The main problem he sees is a common European one: will policy-makers act to preempt a potential fiscal crisis or will it require a crisis to motivate them? ●

Chris Papadopoullos is Economist at OMFIF.

How to avoid Asian monetary tantrums

When should central banks act to stem property market froth?

Taimur Baig
DBS

The battle against Covid-19 is by no means over, but Asia's central banks must start confronting post-pandemic considerations. China is already taking steps to reign in liquidity and credit, along with measures to curb property price surges in some parts of the country. Economic outperformance has come with capital inflow surge, an appreciating currency and a marked rise in bond prices, all of which are making macroeconomic management challenging.

For the rest of Asia, policy considerations are even more complex. Economic normalisation is still a way off, but currencies and property markets have soared. At what point is the current level of interest rate deemed too low? And at what point should monetary authorities take macroprudential measures to stem property market froth and capital inflows fuelling a credit boom?

Markets should be encouraged by the prompt and appropriate actions policy-makers have implemented over the past year. As the pandemic began to rage in 2020, major central banks acted expeditiously to inject liquidity to bring rates to their floor, open or augment emergency credit facilities and provide banks with a range of incentives to keep lending.

By the end of the year, the combined balance sheets of the central banks of G4 economies (the US, euro area, UK and Japan) had jumped to 55% from 35% of gross domestic product. By imposing zero to negative short-term rates, purchasing a wide array of bonds (and stocks in some cases) and underwriting cash transfer programmes, central banks in the industrial world have left little untouched in their policy toolbox.

Asian central banks also reacted through the first year of the pandemic, primarily by cutting policy interest rates. South Korea and Thailand took rates towards the zero bound, while others cut rates by 100 to 200 basis points. These moves, which brought policy rates down to record-low levels, were not questioned by the markets as growth was collapsing. With the exception of India, inflation rates were modest coming into the pandemic.

While no central bank in Asian emerging markets went as far as the G4 central banks in expanding their balance sheets, they nevertheless took a wide array of actions to supplement their rate cuts. Regulatory forbearance was exercised to assist banks with dealing with rising credit risk, asset purchases were expanded to support the bond market (especially in India and Indonesia) and loan guarantees were offered to keep the system of trade credit and payments operating seamlessly.

'By imposing zero to negative short-term rates, purchasing a wide array of bonds and underwriting cash transfer programmes, central banks in the industrial world have left little untouched in their policy toolbox.'

In the first quarter of 2020, the People's Bank of China took steps that were seen as fairly measured at the time. Besides cutting the policy rate by 100bp, the central bank cut the reserve ratio for banks, carried out large open market operations to inject liquidity and set up lending facilities. But these were done incrementally over a few months, with less urgency than in other major economies.

There were two major factors at play here. First, China began 2020 with relatively easy monetary conditions. Second, significant headway was already being made to stem the spread of the pandemic through the second quarter of 2020. Therefore, while the pandemic worsened elsewhere in the world during the second half of the year, activity resumed vigorously in China, reducing the need for further central bank intervention.

A third factor at play may have been China's already formidable debt burden and a resulting reluctance on the part of the authorities to over-stimulate the economy over what was seen as a temporary setback. As 2021 dawned, the PBoC began withdrawing some of its support measures, so much so that market observers began assessing the extent of 'tightening' taking place.

A combination of successful pandemic management and a roaring rebound in exports made China's policy stance seem appropriate. But what about the rest of Asia?

Considering the extremely challenging circumstances they faced, other central banks in Asia did quite well. Exchange rates were allowed to act as shock absorbers during the period of acute risk aversion. No abrupt measures were taken to prevent foreign investors from withdrawing their capital, a measure that tends to tempt policy-makers during times of stress but typically backfires. Little time was wasted in indecision and some regional central banks used the crisis to shore up their

'A combination of successful pandemic management and a roaring rebound in exports made China's policy stance seem appropriate. But what about the rest of Asia?'

external finances by securing swap lines with the Federal Reserve and extending the maturity of their sovereign debt.

Some degree of debt monetisation took place (especially in India and Indonesia), but given the size of the crisis and a general lack of inflationary pressure, markets did not react adversely to these measures. By the end of the year, regional exchange rates had recovered much of the ground lost in March and April 2020, equity markets had rebounded, debt markets were buoyant, credit spreads narrow and liquidity ample.

As we enter the second quarter of 2021, it may make sense for regional central banks to be patient, so that a nascent recovery from last year's recession is not undermined. But if global markets begin to price in policy interest rate lift-off in the US earlier than expected, it will have an outsized impact on emerging markets, ranging from capital flow and exchange rate volatility to liquidity squeeze. Safeguards against that phase of market tantrum need to be built now.

Taimur Baig is Managing Director and Chief Economist at DBS Bank

Markets move towards a green blueprint

Common goals will bring issuers and investors together in the sustainable bond markets

Philip Moore
OMFIF

When cumulative green bond issuance crossed the $1tn threshold last October, it was widely regarded as a champagne moment for sustainable finance. It shows how far the green capital market has come since the European Investment Bank laid the foundations with its first climate awareness bond in 2007.

It was a milestone recognised at a virtual conference on the role of the capital markets in implementing the global sustainability agenda. Co-hosted by OMFIF and DZ Bank, the symposium brought together almost 50 speakers from Asia, Europe and the Americas.

The event coincided with the launch of Italy's €8.5bn debut green bond in March, the largest and longest green issue to date. The bond added to the fast-expanding group of European sovereigns funding through the green market, a process begun by Poland in December 2016. Of the 27 European Union member states, 10 have now accessed the green bond market.

Within the sovereign, supranational and agency market for green debt in Europe, rising issuance volumes will be underpinned over the next five years by Next Generation EU. A temporary instrument to repair the social and economic damage caused by the pandemic, this is a €750bn programme that will fund itself exclusively through the

capital market.

With 30% of its funding earmarked for green bond issuance, Next Generation EU will be borrowing around €50bn annually in green format, making it the dominant SSA issuer in Europe's sustainable capital market. Gert-Jan Koopman, director-general for the EU budget at the European Commission, said that the size of its funding programme, with issuance across the yield curve and supported by a primary dealer framework, will strengthen the environmental, social and governance debt market in Europe and act as a benchmark for other borrowers.

'We need to remain conscious that economies have different development agendas and pathways to achieving their emissions targets. What can work for one nation may not necessarily be applicable in another.'

Willem Littel, senior manager, capital markets & investor relations, BNG Bank

Social bond momentum

The OMFIF-DZ event also highlighted new areas of growth in the sustainable capital markets, especially in the supply of social bonds. According to numbers published by Bloomberg, social bond issuance rose sevenfold in 2020 to $147.7bn.

Marayka Ward, senior credit and ESG manager at Queensland Investment Corporation, said the main driver of the social bond movement was probably the United Nations' 17 sustainable development goals. Adopted at a UN Summit in 2015, these created what the UN calls a 'blueprint to achieve a better and more sustainable future for all'.

Observance of the SDGs has been endorsed in boardrooms throughout the world. 'What started off as a noble concept a few years ago has gathered momentum,' said Ward. 'The SDGs have helped bondholders to see the impact they can have.'

Funding social initiatives that may be small-scale and resource-heavy is one of the challenges of using the capital market in this way. Another challenge presented by social bond issuance is impact reporting. While reductions in emissions can be quantified, the benefits of protecting people from social risks cannot. There is an inescapable element of faith involved in investment in social bonds. 'Although impact reporting is more qualitative, developments over the last year have made us more comfortable that social bonds have a place in the investment universe,' Ward said. 'At least with social bonds we know that we are solving problems. With green bonds, I sometimes worry that rather than removing brown electricity, we are simply adding to the overall energy stock.'

Christian Kopf, head of fixed income at Union Investment explained the benefits of prioritising the good over the perfect. He noted that when the West African Development Bank sold its inaugural social bond in January, it generated an opportunity to invest in a region that had previously been inaccessible to many EU-based funds. By issuing in social bond format, said Kopf, the bank created a new opening for some of these funds to support projects such as women-owned small and medium-sized enterprises in countries ranging from Mali to Côte d'Ivoire.

Substantial growth is also expected in the use of transition bonds to support borrowers' increased commitment to sustainability. Henrik Pontzen, head of ESG at Union Investment, believed this will play a pivotal role in accelerating companies towards carbon neutrality. He pointed out that virtually every company can find green assets to finance. 'But transition bonds are often more impactful and therefore more important because they finance companies which desperately need to become green,' he added. 'I love green bonds. But our aim should be to make the brown green, not to make the green greener.'

This view was echoed by Ingrid van Wees of the Asian Development Bank. She said that in China, which accounts for two-thirds of Asia's carbon emissions, the main challenge will 'not be to promote green finance, but to disincentivise financing of brown, environmentally unsustainable infrastructure projects.'

Adequate incentives for investors, individuals, corporate and banking participants to embrace the climate challenge will drive continued expansion and diversification across the spectrum of sustainable finance worldwide. The rewards for investors able to identify the most successful companies in the transition process may be considerable. 'We all know the companies that have been the pioneers in ESG, but they are expensive,' said Jörg Zeuner, chief economist at Union Investment.

'At some stage we need to think about how we get to a globally agreed taxonomy, rather than different European, Chinese and US taxonomies.'

Fabio Natalucci, deputy director of the monetary and capital markets department, IMF

'At least with social bonds we know that we are solving problems. With green bonds, I sometimes worry that rather than removing brown electricity, we are simply adding to the overall energy stock.'
Marayka Ward, senior credit and ESG manager, Queensland Investment Corporation

'Investors should be targeting the pioneers of tomorrow which will be transitioning into this new and more sustainable economy.'

In the sustainable bond market, the dynamics of pricing need to be well-balanced to incentivise issuers and investors alike. Borrowers generally agree that pricing in the new issue market has settled at levels that offer fair incentives to buyers and sellers.

Eila Kreivi, head of capital markets at the European Investment Bank, explained that in the early days of the bank's green bond programme investors required a pick-up for illiquidity in the nascent asset class. Today, she said, investors are prepared to pay a small premium for accessing top quality bonds in the sustainable capital market.

Ma Jun, chairman of the China Green Finance Committee, said that he would like to see incentives for lenders being prioritised in China. The country already has the world's largest green lending market with RMB12tn ($1.85tn) of loans outstanding at the largest 21 banks. Nevertheless, Ma has proposed the introduction of higher risk weightings for brown assets and lower weights for green loans to turbocharge sustainable lending. 'We can achieve this while leaving overall risk weightings unchanged,' he explained.

Eusebio Garre, head of funding at IDB Invest, said that among lenders there is growing recognition that risk and opportunity are two sides of the same coin. He gave the example of a project closed recently for the energy provider Engie Energía Chile, which raised $125m for the construction of a 151megawatt wind farm. Garre explained that an innovative feature of the financing was that, besides bankrolling the construction of the farm, it monetises the reduction of pollution by setting a minimum price for the offset greenhouse gas emissions.

Coming to terms

The growing volume, depth and diversity in global sustainable finance will add to its complexity and uncertainty. The risk is that this will expose it to abuse, most notably through greenwashing. The combination of these dynamics is already intensifying the debate over standardisation in the sustainable finance market.

It is unsurprising that the expansion, globalisation and variegation of the sustainable capital market is sowing confusion across the corporate, banking and institutional investor community. Over the 10 hours of discussions at the OMFIF-DZ event, close to 20 different names for bonds with some degree of ESG-compliance were mentioned by speakers. There are green, brown and blue bonds. There are climate awareness and sustainability awareness instruments, zero-carbon bonds and transition bonds. There are social and social inclusion bonds, as well as subsets of these, such as affordable housing bonds. Germany has invented twin bonds. Catastrophe bonds were created to support recovery from natural disasters. And the pandemic has given rise to corona bonds and Covid-19 response bonds.

It is little wonder that some market participants appear to be suffering from nomenclature fatigue. 'We need to be careful of inventing too many names for more or less comparable bonds,' said Willem Littel, senior manager, capital markets and investor relations at BNG Bank. This diversity also complicates the process of establishing standards and definitions suitable for consistent application among market participants worldwide.

The EU Green Bond Standard and its taxonomy on sustainable investment is a welcome step towards resolving this conundrum. But some market participants expressed concern that it appears to be a eurocentric solution to a global challenge. 'There is no doubt that in terms of standardisation and benchmarking, the EU taxonomy sets high quality thresholds,' said Littel. 'But we need to remain conscious that economies have different development agendas and pathways to achieving their emissions targets. What can work for one nation may not necessarily be applicable in another.'

Social, climatic and topographical differences between countries also make a one-size-fits-all approach to taxonomy difficult. Tom Meuwissen, general manager, Treasury, at NWB Bank, said he had mixed views on this. 'I understand the need for standardisation is driven mainly by fear of greenwashing,' he said. But he added that as the Netherlands is below sea level, comparisons with the water management strategies of most other countries are meaningless. Besides, said Meuwissen, as many institutional investors now have their own ESG teams applying their own measurements and impact analysis, it is questionable how many will make use of standardised frameworks.

Opinion was divided on how practical or desirable the ambition of a global standard for sustainable finance is. Fabio Natalucci, deputy director of the monetary and capital markets department of the International Monetary Fund, believes that the landscape of disclosure standards remains too fragmented. 'At some stage we need to think about how we get to a globally agreed taxonomy, rather than different European, Chinese and US taxonomies,' he said.

Others argued that in their quest for

transparency and standardisation across the sustainable capital market, regulators, issuers and investors should remain wary of pursuing the perfect at the expense of the good. 'I don't dispute that standards are important, but I believe that we can survive in a world with competing standards,' said Andrew Cross, chief financial officer at the Asian Infrastructure Investment Bank. If standards use different ways of working towards the common good, he suggested, there should be room for them all. 'We all want to do the same thing – which is to make good use of money, generate a decent return and leave the planet a better place than we found it.'

Too much granular information can be counterproductive and even misleading, said Meuwissen. 'The more precise your reporting is, the more certain you can be that it is not fully correct.' More specific to the sustainable financing strategy of NWB, Meuwissen explained that as its lending is balance sheet- rather than project-based, it is impossible to make direct links between the bank's bond issuance and its impact on individual projects.

In the absence of standardisation, issuers can reassure investors by providing regular updates on how their proceeds are being used. Investors have welcomed NWB's 'reverse roadshows', giving them an opportunity to visit the Dutch bank's social housing projects and water authority sites. Ana Guardia, head of capital markets at the Instituto de Crédito Oficial, said that investors appreciated the periodical interviews published with beneficiaries of the bank's sustainable lending. ICO was a pioneer in the social bond market, launching its first issue in 2015, since when it has raised over €3.55bn through seven transactions.

Pontzen welcomed initiatives of the kind described by NWB and ICO but questioned how long reporting which is not project-specific will be acceptable to Union's investing clients. He said that investors are increasingly asking for tangible evidence of the sustainable credentials of the projects their savings are financing.

Regulation: effective or toothless?

There may be other areas of the green capital market where regulation still does not go far enough. For example, Kopf expressed concern that the misuse of proceeds in the green bond market still does not constitute a default. 'That is something we need to rethink,' said Kopf.

Germany may provide a blueprint for an increasingly integrated national response to the climate challenge. The federal government in Berlin appointed a Sustainable Finance Committee in June 2019 to advise on the development and implementation of the country's sustainable finance strategy. The committee recently submitted 31 recommendations, based on the input of 38 experts, aimed at making Germany a leading centre for sustainable finance.

Initiatives of this kind are encouraging. But given that greenhouse gas emissions don't carry passports, speakers generally agreed that ambitious carbon neutrality targets are unlikely to be met in the absence of multilateral cooperation. ●

Philip Moore is a freelance financial journalist.

'Our aim should be to make the brown green, not to make the green greener.'
Henrik Pontzen, head of ESG, Union Investment

Central banks need to change gear

Why the world should move towards monetary normalisation

Jacques de Larosière
European Bank for Reconstruction and Development

David Marsh
OMFIF

It's time for central banks to prepare financial markets to regain more influence over longer-term interest rates, braking the move towards fiscal dominance and alleviating the threat of another economic collapse. Major central banks should envisage shifting gear away from trying to hold down long-term bond yields and towards monetary normalisation.

In Europe, what happens in Italy will be crucial. Mario Draghi, Italy's new prime minister, played a pivotal role as European Central Bank president in pushing the ECB towards highly accommodative monetary policies. He now has the chance of stabilising Italy, improving the quality of European fiscal policy and increasing public investment.

The world must start to move gradually towards monetary policy normalisation. Co-operation between the monetary authorities in the leading countries will be key, in line with standard practice not just in the 1980s and 1990s but also during the 2008 crisis.

Dangers of overheating are intensifying. One example has been the last few weeks' speculative US stock market gyrations. Easy money in the US, Europe and Japan, combined with extensive fiscal stimulus witnessed in President Joe Biden's $1.9tn package, are stoking risks of inflation well above central banks' medium-term target of 2%. Respected figures such as former US Treasury Secretary Larry Summers or Charles Goodhart of the London School of Economics are issuing plausible warnings of escalating inflation expectations coming to a head in 2022.

The need for remedial action is particularly acute in Europe, where the ECB has run negative interest rates since 2014 and has expanded its balance sheet three to one/two-fold in that period. Low or negative interest rates induce a fatalistic mindset that lowers propensity to invest. Under what John Maynard Keynes called the 'liquidity trap', investors play safe by placing savings in very short-term instruments rather than deploying them longer term, where low interest rates bring them inadequate returns for higher risks.

The ECB is becoming caught in a trap which removes its flexibility for running an appropriate monetary policy. Through its programme of government bond purchases, the ECB has become a de facto agent of fiscal policies, buying the majority of government bond issuance in 2020-21.

Through its ability to tilt buying towards the more highly indebted states under the pandemic emergency purchase programme, the ECB is now seen by governments and capital market participants as the controller of longer-term yields, usurping the traditional functions of markets. An alternative path is available but following it will not be easy. The ECB should relax an overly rigid fixation on the 2% inflation rate, accepting that it has undershot its target in recent years, at a time when equilibrium inflation has been around 1% to 2%.

Failure to meet the 2% level should no longer be used as an excuse for unnecessary easing. Systematic buying of public bonds should not open the way for governments to finance vast stimulus plans without necessary conditions, including reform in increasing the efficiency of public spending and giving priority to public investment instead of current redistribution. The project management strictures in the European Union's €750bn recovery fund package of grants and loans are welcome. They should assure that major recipients like Italy spend the money wisely and well – relieving the burden on the ECB.

The ECB should further acknowledge that zero or negative interest rates are not a natural phenomenon but are, in large part, the result of heavy central banks purchases which can be reversed over time. Preparing for European interest rates to return to more normal levels could be the first step to a more productive post-pandemic period of higher growth and investment. Without this necessary change in mindset, we may have to wait a very long time.

Monetary policy should never be the only game in town. We are told that fiscal policy is regaining the upper hand. But that depends on the ability and willingness of central banks to purchase the 'virus-bonds'. To secure the future health of the world economy, that is a condition that central banks cannot allow to continue indefinitely. •

Jacques de Larosière is former Governor of the Banque de France and former President of the European Bank for Reconstruction and Development. David Marsh is Chairman of OMFIF.

Europe faces its biggest question

Governments must decide how to pay for pandemic spending

Agnès Belaisch
Barings Investment Institute

This is a pivotal year for Europe. Vaccines will free us from restrictive lockdowns and solve the health crisis. The pandemic's economic impact, however, will remain and we will soon find out how governments will pay for it. Lavish fiscal policy has provided financial support to households and companies so that things can return to normal quickly once the health crisis is over. Nearly a third of a year's output has been spent in this effort: fiscal measures add up to 32% of euro area gross domestic product.

Governments cannot delay the financing decision for another year, since the suspension of the European Union's 3% GDP deficit limit expires at the end of 2021. A decision is needed by the middle of the year so that 2022's budgets can be prepared accordingly.

Some argue that austerity need not return. Low, even negative, interest rates make public debt easily serviceable and the stock can just be rolled over, transforming public debt into a sort of perpetual bond. Others see the 3% fiscal deficit rule as necessary for growth and economic stability. After having crossed many Rubicons in 2020, we are approaching the banks of another already.

There is an interesting twist to the debate. The side that argues for a paradigm shift is aided by tailwinds from the west. Several former US government officials and policy advisers are recommending that President Joe Biden implement another large spending programme, despite 2020's 18% deficit.

They explain that, in the context of a shock like the pandemic, fiscal deficits are expansionary, with each dollar spent on investments and infrastructure, as well as research and development, returning more than a dollar of GDP. In other words, the spending will pay for itself. Top-down fiscal anchors should be done away with and debt does not matter. In times of low interest rates, borrowing to spend is a no-brainer.

Back in Europe, where interest rates are at or below zero, cheap debt servicing also helps the case for more spending. The EU recovery fund is preparing to borrow hundreds of billions of euros to invest in digital and green technologies that will raise potential growth. The cost will stay low, as inflation is nowhere to be seen. Core inflation has reached a nadir, and the European Central Bank is further from its target than ever. Even when the economy recovers, inflation is likely to return to its prepandemic level of only around 1%, much below its 2% target.

With the need to stimulate inflation, rather than slow it, monetary policy needs to remain accommodative. With its most efficient tool, the pandemic emergency purchase programme, expiring at the end of the pandemic, the ECB will have to stay on the sidelines and cheer national governments as they deploy their recovery stimulus to relaunch growth and, hopefully, boost inflation.

However, even though debt is cheap, it is impossible to imagine that Europe will let go of its emphasis on fiscal discipline. In the absence of a common fiscal policy, deficit and debt targets are a useful tool to maintain a degree of harmonisation across the euro area. But reactivating the old 3% deficit limit is not only unrealistic, it is dangerous. A brutal adjustment through large tax increases or spending cuts would risk pushing Europe back into a recession. As for the 60% of GDP debt limit, it has long been irrelevant. So how will Europe reform its fiscal guidelines?

It will take time. The EU should seriously consider putting a limit on how much could be spent on annual debt servicing, based on GDP. Education and research spending could be ringfenced, not counting towards the overall spending cap. A limit could also be set on net financing needs every year, again as a ratio of GDP. This was, in fact, the very metric used to assess debt sustainability during the 2010 Greek debt crisis.

'Spending will pay for itself. Top-down fiscal anchors should be done away with and debt does not matter. In times of low interest rates, borrowing to spend is a no-brainer.'

The pros and cons of every option will have to be weighed. In the meantime, it is probable that the only decision taken this year will be to give governments more time to balance their books. •

Agnès Belaisch is Chief European Strategist at Barings Investment Institute.

ECB must future-proof monetary policy

Will the strategy review unveil gems to bring Europe back to prosperity?

Hani Kablawi
BNY Mellon

In the second half of 2021, the European Central Bank will conclude its first strategy review since 2003. The ECB needs to future-proof itself and ensure its monetary policy framework can deliver for the currency union over the coming decades.

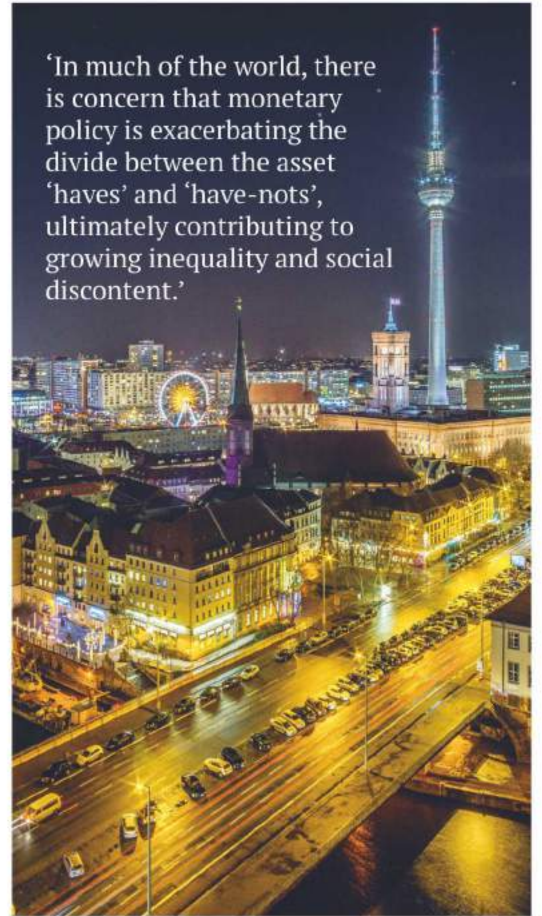
Although much of the euro area is facing its third wave of Covid-19, the commencement of vaccination programmes worldwide offers a way out. Nonetheless, even if life can approach something close to 'normal' by the end of the year, in a monetary policy context, it is hardly the kind of normality which makes life easy for the ECB.

In a speech detailing the preliminary considerations of the review in September last year, ECB President Christine Lagarde made it clear that 'unconventional policy' was already 'normal'. Low inflation, largely driven by structural factors beyond the ECB's control, has seriously curtailed its ability to move rates back to pre-2008 financial crisis levels and reduce its asset purchases. Economic scarring left by the pandemic risks strengthening such pressures.

As a result, the low starting point for monetary policy means markets may immediately question whether the ECB is able to loosen financial conditions when a new shock occurs. To address such credibility concerns, the ECB and its peers globally will need to step up policy innovation to ensure transmission mechanisms continue to function at the zero-lower bound.

Mitigating the side effects of extraordinary policy loosening is a challenge given the potential socio-political ramifications. Despite the protestations of central banks globally, large-scale asset purchases are seen as having contributed to asset price inflation or other forms of mispricing relative to fundamentals over the past decade. In much of the world, there is concern that monetary policy is exacerbating the divide between the asset 'haves' and 'have-nots', ultimately contributing to growing inequality and social discontent.

Already, we have seen the New Zealand Reserve Bank face pressure by the national government to incorporate house prices into their monetary policy remit. The general consensus in the central banking community is that such forms of direct intervention in specific asset markets do not belong in monetary policy objectives and should remain within the purview of macroprudential authorities as they risk adverse unintended consequences. Measures fit for one area of the economy may hurt much of the rest.



'In much of the world, there is concern that monetary policy is exacerbating the divide between the asset 'haves' and 'have-nots', ultimately contributing to growing inequality and social discontent.'

On the positive side, the direction of travel in the European Union suggests that political consensus may move more in favour of fiscal expansionism. Germany has recently announced further suspension of its debt brake and political parties more partial to fiscal integration in Europe, in particular the Green party, look set to do well in the German elections later this year.

In Italian Prime Minister and former ECB President Mario Draghi, the ECB now has a formidable ally in the corridors of political power. Many of the objectives of Next Generation EU recovery packages are aligned with the ECB's priorities on fiscal integration and a green future for Europe. Taking full advantage of favourable political trends must also comprise a part of the ECB's review.

Nearly a decade ago, 'whatever it takes' was the rallying cry. 'No stone unturned' was the pledge as the ECB commenced its review. We hope Frankfurt will have plenty of gems to unveil as the euro area and wider EU seeks a return to prosperity. ●

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

The return of supply-side economics

Can Draghi use the European recovery fund to avoid Italy's past mistakes?

Massimiliano Castelli
UBS Asset Management

The appointment of Mario Draghi as prime minister of Italy in February boosted hopes that the former president of the European Central Bank will do what nobody else has managed to: address Italy's structural weaknesses and raise its growth potential to the level of the euro area.

Expectations are high in Italy and across Europe. If Draghi succeeds in effectively leveraging the resources of the €750bn European recovery fund, it will facilitate the ECB's exit from extraordinary monetary policy measures as suggested by former Governor of the Banque de France Jacques de Larosiere and OMFIF's David Marsh (p. 30). Furthermore, it will be politically easier for Germany and other 'core' European countries to make the case for further fiscal integration across the euro area and so finish the 'incomplete' economic and monetary union project.

In his first public speech to the Italian parliament, Draghi made clear that supply-side policies are the priority for Italy, very much in line with recommendations made by the European Commission. Closing the growth gap between Italy and the euro area will be achieved through a combination of structural reforms – taxation, public administration and justice – and a broad public investment plan focused on digitisation and green infrastructure. These supply-side policies are very different from demand-side policies, which have been launched over the last year to keep economies afloat during the pandemic.

'Draghi's focus on supply-side structural reforms will come as no surprise to those who followed his years as president of the ECB.'

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Draghi's focus on supply-side structural reforms will come as no surprise to those who followed his years as president of the ECB. Since the 2008 financial crisis, the major concern of central bankers has been monetary policy being 'the only game in town'. The pandemic has unleashed another game – fiscal policy – as resistance to rising public debt has been wiped out by the economic carnage caused by global recession. Another game will soon be added: structural supply-side reforms, courtesy of the European Union-sponsored recovery fund.

Structural reforms and public investment plans for Italy such as those envisaged by Draghi and supported by the ERF provide great opportunities. The experience of countries such as Ireland and some central and eastern European countries in leveraging resources provided by European funds shows that the impact can be substantial.

But there are also significant risks. Italy has a long track record of an inability to address structural weaknesses, largely as a result of its volatile and fragmented political class. Italy's take-up of EU structural funds is low and the country has been unable to reduce the economic gap between the north and south, despite a massive injection of EU structural funds over the last few decades.

Why should it be different with the ERF? Italy's poor use of EU funds in the past has been closely associated with the institutional weakness of regional governments in charge of investing said funds. The ERF will be a national plan under the control of the central government. We will see whether Draghi can find success where others have failed. •

Massimiliano Castelli is Managing Director and Head of Strategy and Advice for Official Institutions at UBS Asset Management.

10 questions for ECB strategy review

Tensions to rise as recovery nears

Danae Kyriakopoulou
OMFIF

The conclusion, due in September, of the European Central Bank's strategy review is likely to reignite tensions within its governing council after a period of solidarity fighting Covid-19. Here are 10 issues to watch in the first comprehensive examination of the bank's monetary policy since 2003.

1. Is 2% fit for purpose?

Over the past two decades, fear of rampant inflation has given way to anxiety over deflation and 'lowflation'. The debate on a revival of inflation has resurfaced in view of the size of the pandemic stimulus. There is pressure for adjusting the policy strategy to reflect the uncertainty. The ECB's aim of inflation 'below, but close to, 2%' may not be fit for purpose. Commenting on the 2% target, Christine Lagarde, ECB president, stated that in the lower inflation environment 'ensuring that there is sufficient space above zero to re-empower conventional monetary policy becomes more important.'

2. Clarity on time horizons and 'make up' strategies

The ECB vaguely defines the horizon for achieving its objective as the medium term. More precision may be needed. Former ECB Executive Board Member Peter Praet highlighted that the term may not need a 'revolution', but that it would be helpful to have 'a narrative to define what is meant by the medium term'.

3. Measuring inflation, reimagined

If 2% and medium term are up for discussion, so is inflation. To monitor inflation, the ECB measures changes in the harmonised index of consumer prices. There is concern that this may not reflect costs consumers face. Lagarde hinted that the ECB is examining changes. The ECB is not considering 'moving the goalposts' but 'future-proofing how we measure inflation'.

4. Normalisation versus 'QE-infinity'

Since the last review, unconventional monetary policy has entered the ECB's toolkit. The pandemic prevented any serious discussion of 'normalisation', but the closer Europe gets to recovery, the more pressing this question will be.

Questions will arise about whether there should be an automatic trigger for exiting unconventional policy. So will questions over reinvesting assets on the balance sheet and whether these should be sold to the market or maintained until maturity.

5. Resolving fiscal-monetary tensions

The prolonged pursuit of unconventional policies is making exit more risky. Praet warned that the ECB needs to 'be careful about the procyclicality in central banking in terms of sovereign debt ratings for the collateral and asset purchase programme.' He highlighted the potential risks to profitability and central bank negative equity that may arise from the blurring of the frontiers between monetary and fiscal policy as central banks take on more government debt.

6. Managing expectations at times of growing challenges

Some on the governing council have warned of the central bank taking on too many tasks. This applies to the scale of monetary easing as well as expanded interests, such as climate change. The result may be that the ECB could become a convenient 'scapegoat' for governments. According to Fratzscher, the ECB is in danger of not living up to its perception in Germany as a 'moral player'.

7. Addressing climate change with monetary policy

Climate change was not on the central banking agenda in 2003. Today, it is a key issue. The ECB is already incorporating climate considerations in its operations. However, there are still divisions on addressing climate risks across the governing council. Because of these differences, only limited action is likely.

8. Preparing for crisis

Most of the questions in the review focus on one theme: the balance between discretion and rules. Research on central banks with different mandates can be helpful. In reviewing its strategy, the ECB must ask itself not what mandate delivers best in good times, but what mandate delivers best during a crisis.

9. Maintaining credible communication

'The reputation of the ECB in Germany has taken a big beating, as it has not managed to navigate different views in a constructive way', warned Fratzscher. The heterogeneity of the ECB's governing council, a key challenge during the era of Lagarde's predecessor Mario Draghi, remains an underlying risk. The strategy review must lead to a process where this heterogeneity helps the ECB communicate credibly.

10. Getting the timing right

In communicating credibly, it is not only the 'what' that matters, but also the 'when'. Discrepancies in views are likely to become more important as the crisis recedes. By setting a bureaucratic target of September, the ECB risks being caught in a storm of its own making, when the environment will be less propitious for consensus. ●

Danae Kyriakopoulou is Chief Economist

Currency disputes may soon resurface

Biden administration could face new debates over global imbalances

Mark Sobel
OMFIF

The pandemic profoundly changed external sector and currency market dynamics in 2020 and may do so further in 2021. US expansion may herald a return to debates about global imbalances and currency wars.

The US macroeconomic policy stance is more aggressive than elsewhere. The Organisation for Economic Co-operation and Development estimates that President Joe Biden's $1.9tn American Rescue Plan could raise US output by around 3% to 4% on average in the package's first full year. Many forecasters project US growth of 6% to 8% in 2021. Europe's macroeconomic response, while strong, is restrained in comparison. European fiscal policy may begin withdrawing stimulus later in 2021. China's 6% growth target for 2021, even if a lower bound, is modest relative to forecasts of 8% or higher, signalling authorities' desire to run restrained policies to curb leverage and lessen risks.

These stances could have major ramifications for global current account positions. The US was running current account deficits of around 3.3% of gross domestic product in the second and third quarters of 2020. Its merchandise goods deficit was nearly two percentage points of GDP higher. The OECD has estimated Biden's fiscal package could raise the US current account deficit by three-quarters of a percentage point through the first quarter of 2022. That could mean a US current account deficit around 4% of GDP in 2021.

This widening current account deficit could have profound global implications. On the plus side, for the US, higher imports will act as a safety valve, reducing inflationary pressures. For the rest of the world, it will boost growth between one-quarter and half of a percentage point in the euro area and China according to the OECD, and even more for Canada and Mexico. It is worth placing this possible jump in US current account deficit in historical context. In the early to mid-1980s, the US external deficit surged on the back of an imbalanced policy mix that sent the dollar soaring. These policies included Chair of the Federal Reserve Paul Volcker's tough restraint to wring inflation out of the economy and President Ronald Reagan's expansionary fiscal policy. Amid strong protectionist pressure, Secretary of the Treasury James Baker launched the Plaza Accord in 1985.

In the 2000s, protectionist pressures surged, reflecting deep and legitimate concern over the sharp rise in China's current account surplus, currency undervaluation and unprecedented excessive currency market intervention. This happened amid dislocations in America's job market, despite strong US growth and falling unemployment.

After the financial crisis, China continued to amass reserves, even while its current account deficit plummeted. Other Asian countries ran strong trade positions and built up reserves. Germany's already excessive current account surplus soared, rising above 8% of GDP, due to excess saving and fiscal restraint.

With the advent of fracking, the US current account deficit declined and hovered around 2%+ of GDP in the last decade. But that did not quell US concerns over external sector developments under Presidents Barack Obama and Donald Trump. Whatever problems the US may have brought on itself, it has fairly perceived that many in the rest of the world have long pursued export-led growth models and seen US demand as an engine of growth. In the past, America pressed others to boost domestic demand and not view the US as the importer of first and last resort, but with mixed results.

Even before the Biden package, the International Monetary Fund was projecting a widening in Germany's current account surplus back to 7% of GDP. China's surplus has risen, in large part due to pandemic considerations such as the cessation of tourist outflows and strong pandemic-related exports. Other Asian surpluses are large as well, and many Asian economies are again intervening heavily in currency markets.

These developments collectively imply that foreign countries will see positive net exports, with GDP growth exceeding domestic demand growth. These countries may be perceived in America as skewing global demand, absorbing jobs and growth from the US, amid the surging current account deficit.

The US dollar could be a wild card. Earlier this year, markets expressed extreme bearishness about the dollar's prospects in January. The market was wrong. The dollar has strengthened on the back of higher interest rates, reflecting the Biden fiscal package among other things. Further dollar strengthening could contribute to a wider US external deficit and aggravate these potential concerns.

The Biden administration could soon face another challenge. •

Mark Sobel is US Chairman of OMFIF.

Fed can crush 'bond vigilantes' if it chooses

Unruly trading in Treasury market may force Fed deeper into toolkit

Pierre Ortlieb
OMFIF

The Federal Open Market Committee met in mid-March amid heated debate over the nature and state of the market for US government bonds, where long-term yields have burst to levels last seen in early 2020, before the Covid-19 pandemic.

The surge was highly unusual, even measured against previous episodes of instability in the world's largest and deepest market (figure 1). Driven primarily by rising growth and inflation expectations as well as the prospect of earlier than expected interest hikes, this spike has been exacerbated by a series of tepid government bond auctions. Demand for US Treasuries, measured by the bid-to-cover ratio, has fallen steeply since the start of the year, reviving suggestions that 'bond vigilantes' will once again police unruly fiscal policy.

The drop in demand comes during a change in the composition of holders in the Treasury market (figure 2). Primary dealers, who absorb issuance at auctions, last week sold off their inventories of US government bonds by the largest amount on record, by $64.7bn to $185.8bn. For the FOMC, this should signal banks' concern around the forthcoming end of the supplementary leverage ratio exemption.

This pandemic regulatory relief, which exempted central bank reserves and US treasuries from capital requirements, is set to expire on 31 March, putting banks under pressure to trim their portfolios. Both reserves and bond supply are set to swell during 2021, with the former rising due to the wind down of the Treasury general account at the Fed and the latter due to Congress passing the American Rescue Plan, as well as a potential future infrastructure package.

Does it make sense for essentially two forms of cash – reserves and US government bonds – to add to tier 1 capital requirements? Either way, uncertainty over whether the exemption is set to continue has contributed to volatility, and Chair Jerome Powell may feel compelled to explain the Fed's thinking.

But even if the SLR exemption were to continue, it's not clear that banks would be able to absorb issuance to any meaningful degree. JP Morgan – by far the most important player in intermediating flows of treasuries and reserves – is capped out in its ability to perform this function. As Zoltan Pozsar, managing director of Credit Suisse, noted in his subscriber newsletter on 12 March, its 12% tier 1 capital target and desire to avoid rising from a 4% to 4.5% globally systemically important bank surcharge 'effectively operate as an 'asset cap'. Similar regulatory constraints hold for many other key banks, while Wells Fargo still faces an asset growth ban imposed by the Fed in 2018.

Banks won't be able to assist much in the intermediation of the forthcoming flood of reserves and treasuries. Meanwhile, money market funds will be able to absorb shorter-term issuance – especially bills, which have been in frustratingly short supply in recent months – but provide little relief for the long term.

Figure 2 suggests that it is foreign buyers – especially central bank reserves managers – who absorb long-term issuance. And changes in the costs of currency hedging suggest that the Treasury market is set to become much more attractive to this group. A large share of these international portfolios hedge their Treasury holdings back into their domestic currency, typically on a three-month rolling basis. In the past, particularly in 2019, this meant that treasuries provided less yield than domestic bonds. For a Japanese pension fund, a hedged 10-year treasury was less attractive than a domestic Japanese government bond (figure 3).

This trend has reversed dramatically since

1. Unprecedented spike in yields

10-year US Treasury bond yield, 100 = start of bond sell-off, trading days since start of sell-off

Source: Refinitiv, OMFIF analysis

the onset of the pandemic and has been intensified by the recent steepening in the US yield curve. The convergence in global long-term interest rates brought about by Covid-19 has reversed, with US treasuries now providing significantly more yield even on a hedged basis. This could bring yield-starved reserves managers and pension funds back into the US government bond market, partially answering the question of where long-term issuance will end up.

The changing composition of Treasury buyers is important and buys time for the FOMC to consider its options. But the US government bond market is not your typical market.

The demand and supply dynamics that might apply to other asset classes do not govern the Treasury market in the same way – the yield on government bonds is, to a large extent, a policy choice. The surge in yields in 1994 especially should serve as a reminder that in the US, the 'bond vigilantes' led by Alan Greenspan, were keen to impose deficit reduction on the upstart administration of Bill Clinton.

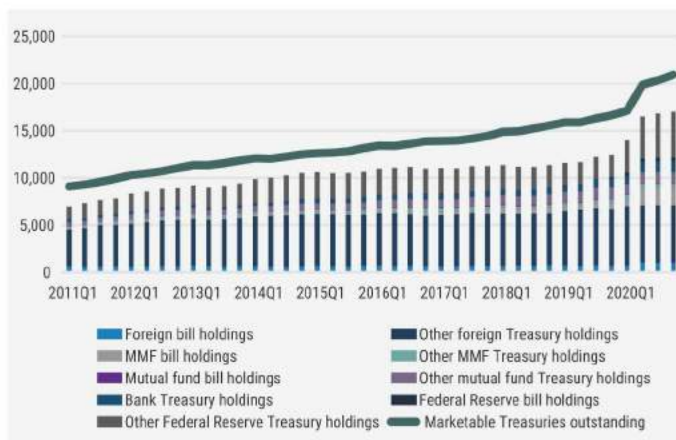
While inaction was the policy choice in 1994, the Fed has tools to stem the rise in yields if it desires. In its June 2020 meeting, the FOMC discussed the possibility of yield curve control, deciding at the time that 'it was not clear that there would be a need for the Committee to reinforce its forward guidance with the adoption of a YCT policy.'

Now that the Fed's forward guidance is increasingly in doubt, however, it may be worth revisiting this discussion. Australia's experience with YCC – which the FOMC identified as 'the most relevant for current circumstances in the US' – has been relatively successful in keeping a strict cap on its target three-year yield without requiring excessive purchases of government debt. This may provide a simple path to alleviating pressures on US government bonds.

The Treasury market presents a challenging problem for the FOMC. Yields have risen dramatically, at a pace that has proved difficult for markets to digest and has resulted in considerable volatility. This is concerning, but has so far had little spill over into other asset classes, and financial conditions remain extremely loose.

If the Fed chooses to stay put and strengthen its forward guidance, it may leave the Treasury market at the whim of forces with highly uncertain magnitude and direction. This may play out in its favour. But if financial conditions get out of hand, the Fed may be forced to eventually quell long-term yields with more powerful policy tools on unwanted terms. ●

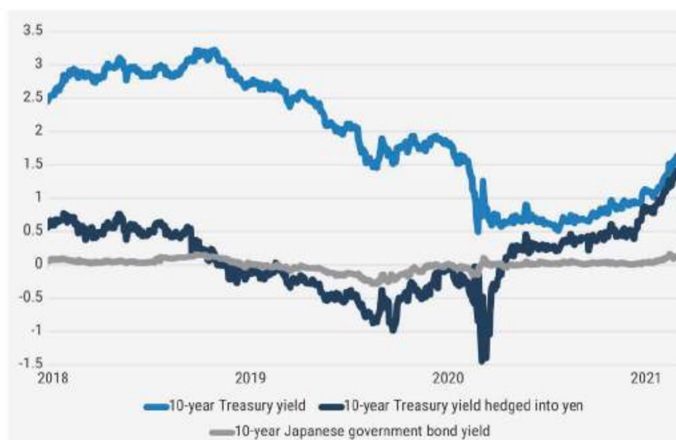
Pierre Ortlieb is Economist at OMFIF.



2. Fed and foreign buyers hold large share of long-term treasuries

Holdings of US Treasury bills and longer-term securities for select institution types, $bn, 2011Q1-present

Source: Financial Accounts of the United States - Z.1, OMFIF analysis



3. Growing hedged Treasury returns will bring foreign accounts back into market

Yields on Japanese government bonds, US government bonds and yen-hedged US government bonds, %, 2018-present

Source: Refinitiv, OMFIF analysis

Bond debate highlights Treasury tensions

Debt management must evolve beyond the narrow view of lowest cost

Amar Reganti
Wellington Management

When Janet Yellen was confirmed as US Treasury secretary in January, questions inevitably resurfaced as to whether the Treasury should begin issuing a 50-year or even a 100-year ultralong note.

Just a few years ago, the Treasury's debt managers, in consultation with the Treasury Borrowing Advisory Committee, reviewed the potential issuance and concluded that it would not meet the Office of Debt Management's mandate of financing the government at the lowest cost of debt. Moreover, an ultralong note would present a challenge to 'regular and predictable' issuance.

The ultralong bond debate is an example of the inherent tension between lowest-cost issuance and innovation and improvements to the Treasury market. Proponents of the ultralong note argue that it would enable the Treasury to increase the weighted average maturity of its portfolio, lock in low rates and diminish rollover risk. But under the current framework, these are problematic arguments.

First, it is unlikely that the Treasury could issue enough ultralong debt to substantially shift its WAM without disrupting financial markets. While the Treasury and TBAC have constructed a WAM framework, given the sprawling nature of the Treasury's markets, there are significant challenges in its implementation and usage.

Short-dated bond issuance on an ex-post basis has historically met the criterion of lowest cost in most scenarios, particularly during periods of upward-sloping yield curves. The Treasury has remained concerned about rollover risk, but primarily from an operational, climate-risk and cyber-risk perspective (such as the disruptions caused by Hurricane Sandy in 2012). Beyond operational issues, lack of appetite for short-dated Treasuries is unlikely to lead to much rollover risk.

By creating an ultralong point on the Treasury curve beyond the 30-year note, private-sector ultralong issuance may grow over time, as price discovery, hedging and benchmarking would improve. On balance, this would be a positive tailwind to expand the breadth of dollar fixed income markets.

'There are plenty of reasons for the Treasury to issue ultralong debt; they just have little to do with the lowest cost mandate and a WAM framework.'

Debt managers are often forced to think about the 'caring and feeding' of the market microstructure that has built up around the rest of the Treasury curve. The wide usage of Treasuries for collateral, regulatory, benchmarking, liability-matching and duration-management purposes is much of what makes Treasuries desired by such a variety of market participants. This versatility enhances the overall depth and breadth of US capital markets. The dominance of Treasuries in almost every feature of global market operations makes it impossible to separate them from the status of the dollar as a reserve currency.

But maintaining the financial stability of the microstructure, and innovating to improve it, can conflict in the near and intermediate term with the mandate of issuance at the lowest possible cost. This highlights the tension between an issuance strategy that will improve the Treasury's markets in the long term (including the benefits to dollar fixed income markets and their associated functioning) and the mandate to issue at the lowest possible cost.

Resolving this conflict and expanding the mandate beyond lowest cost is not in the remit of Treasury's talented domestic finance civil servants. It would need to be resolved by appointed officials, much as regular and predictable issuance was heralded by Paul Volcker during his tenure as Treasury under secretary.

To address this inherent tension, the next evolution of debt management should go beyond the narrow and parochial view of lowest cost and incorporate market microstructure, financial stability and the dollar's reserve currency status. However, the Treasury has not had a Senate-confirmed under secretary for domestic finance since Mary Miller in 2014, which creates a longer-term stasis around this critical issue.

As the pandemic recedes and economic recovery starts to take shape, the Treasury should begin thinking beyond just lowest cost. ●

Amar Reganti is a Managing Director and Fixed Income Investment Director at Wellington Management. He was formerly the Deputy Director of the US Treasury's Office of Debt Management.

How long will the reflation trade last?

Structural factors are likely to keep a ceiling on interest rates

Nathan Sheets
PGIM Fixed Income

Analysts expect the global economy to expand by 6% or more this year, the fastest pace in decades. The US will lead the way, but growth in Europe should also bounce back as the year progresses. And, of course, the Chinese economy will record another solid performance.

Along with these rising growth expectations have come concerns about inflation. As the global economy shakes off the constraints of the pandemic, demand seems poised to run ahead of supply, at least in some sectors. Firms will need time to bring back workers, formulate production schedules, restart supply chains and ramp up production. Under such circumstances, sporadic bottlenecks and shortages could drive up inflation.

The seismic shifts in growth and inflation prospects have, in turn, kicked off a massive 'reflation trade' in global bond markets. While the US has been the epicentre of this, yields are up significantly elsewhere as well.

I'll leave it to the bond traders to figure out exactly where and when yields peak, but two related questions are important. First, how will central banks respond to the surge in rates? Second, what are some circuit-breakers that could stall — or reverse — this recent rise?

On the first of these questions, the increase in long-term rates creates a quandary for central banks. Supporting the economy has been their main objective through the pandemic, so the brightening of prospects is welcome. More fundamentally, many central banks have wrestled with below-target inflation for years. Reflation is exactly what they have been pursuing.

Even so, central banks must watch rising rates with caution. If the move outpaces fundamentals, it could cut into the recovery.

But other factors could also short-circuit the rise in rates. First, as the year progresses, some elements of the 'strong rebound' narrative may fail to materialise. For example, the vaccination campaign could stumble or households might remain cautious in their spending behaviour even after being immunised.

A second possibility is that the rise in rates might bite back and slow the recovery. Sectors such as housing, cars and consumer durables would be vulnerable.

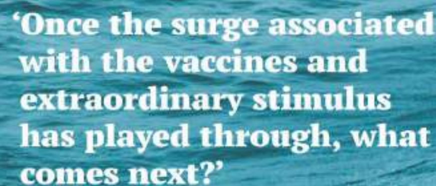
Third, markets are forward-looking and, as such, are likely to become concerned about the prospects for the economy after the rebound. Once the surge associated with the vaccines and extraordinary stimulus has played through, what comes next?

In principle, the private economy and 'normal' income-generating mechanisms should by then be sufficient to support the expansion. But if spending is pushed too far above sustainable levels, the eventual downward adjustment could be bumpier than anticipated.

More generally, despite the expected rebound in activity this year, the medium-term outlook for the global economy remains moderate at best. Many of the structural trends that weighed on performance in the years before the pandemic, including aging demographics and high debt levels, are very much still in place.

These factors are likely to restrain growth and inflation — and put a ceiling on rates — over the medium term. ●

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



Is volatility set to return?

Rising debt levels and inflation could end the 'great moderation'

Didier Borowski
Amundi

Since the mid-1980s, the volatility of output growth and inflation has declined to a post-war low in most member countries of the Organisation for Economic Co-operation and Development. A number of factors have been put forward to explain this period, known as the 'great moderation'.

First, many structural changes have taken place: increasingly sophisticated technology has enabled companies to optimise inventory control; development and deregulation of financial markets have made it easier for companies to finance their investments; the transition from industrial to service economies in developed countries has helped to smooth the business cycle; and the growth of global trade and the free movement of capital have increased the flexibility of economies, making them more stable.

Second, progress has been made in terms of economic policy. Central banks have gained greater independence, which has enabled them to better fulfil their primary responsibility of ensuring price stability. Central banks have become more transparent in their operations and have improved their communication with the markets. The result of these developments has been a better anchoring of inflation expectations.

Third, external shocks have become rarer and less destabilising. In short, the decline in macroeconomic volatility is due to both good policy and good luck. Surprisingly, the 2008 financial crisis did not end the great moderation. In the US, for instance, output volatility was never as low as in the 10 years preceding the Covid-19 crisis.

Looking ahead, it is open to question whether some of the factors that led to the great moderation will act in the opposite direction. The reshoring of certain value chains in the wake of the pandemic, the fragility of the service sector and the expected rise in inflation are all factors that are paving the way for bumpier cycles.

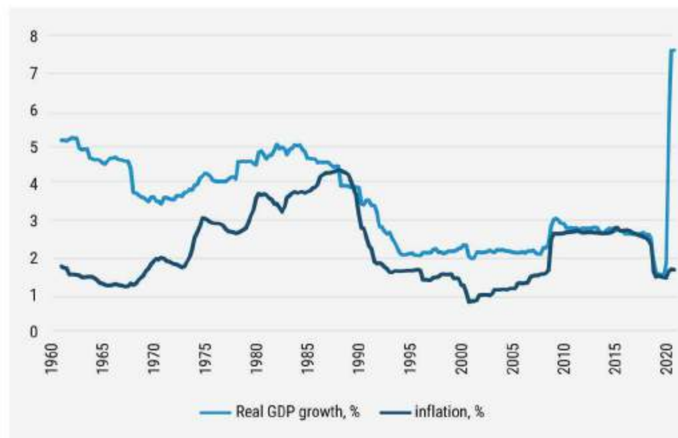
This may lead to an unstable scenario of 'fiscal dominance' in which expansionist fiscal policies are combined with accommodative monetary policies to alleviate the debt burden. Such a situation would put central banks in the difficult position of having to contain inflationary pressures and maintain financial stability at the same time. It's questionable whether the ability of the policy mix to smooth out cyclical fluctuations will be as effective as in the past.

Rising public debts and inflation could be an obstacle to stabilisation policies. Private and public debt levels have reached new heights with the Covid-19 crisis, surpassing previous peaks reached at the end of the second world war. Rising debt levels are likely to dampen domestic demand. While inflation is welcome in facilitating deleveraging, it can also put central banks in trouble, especially if inflation expectations are not well anchored.

Debt accumulation is a complete game changer from a macrofinancial standpoint. Too sharp a tightening of monetary conditions (an increase in short- and long-term interest rates) would inevitably lead to a marked correction on risky assets and trigger a balance-sheet recession. And economies may face more shocks in the future, such as epidemics, climate events and conflicts. In a nutshell, both good policies and good luck may disappear at the same time.

The recent surge in output volatility has been accompanied by an equally large increase in earnings volatility, while inflation volatility has remained contained at this stage. And volatility on markets has so far been limited thanks to the ultra-expansionist policy mix and the absence of inflation. This may not last. Bumpier business cycles would inevitably be accompanied by a resurgence of volatility in financial markets. Investors must be warned. ●

Didier Borowski is Head of Global Views at Amundi.



1. US macroeconomic volatility

10 year rolling standard deviations

Source: Amundi Asset Management as of end-December 2020. Author's calculation based on Eikon-Datastream data.

SDR proposals could reset system

Significance spreads beyond help for emerging nations

David Marsh
OMFIF

Willem Middelkoop
Commodity Discovery Fund

The International Monetary Fund's special drawing right – the international reserve asset created in 1969 to prepare for a new dollar crisis – is undergoing a renaissance, with important worldwide repercussions. The announcement of by far the largest-ever increase in SDR allocations, which will greatly improve the liquidity of many developing nations, signals alignment between the US and China in a key area of global monetary power.

The immediate reason behind the decision on 19 March by the G7 group of industrial nations was to help low- and middle-income countries hit by the pandemic. UK Chancellor of the Exchequer Rishi Sunak, speaking after a finance ministers' meeting under the UK's G7 presidency, said the new capital injection ensured that 'no country is left behind'. Kristalina Georgieva, IMF managing director, said the planned SDR allocation – to be finalised next month – would accompany measures on 'debt vulnerabilities' and concessional finance.

The action has wider significance. The US now agrees with using the IMF's balance sheet to boost world liquidity. One side effect of the pandemic is that the IMF's accounting unit is advancing beyond its status as an arcane currency basket – and could become an essential part of a future monetary reset.

The G7 decision, already foreshadowed by agreement at G20 level, is likely to more than triple SDR allocations by at least $500bn. This reflects a change in US policy to back measures strongly advocated last year by China as well as leading European and African countries.

G7 countries will coordinate with the IMF to explore how countries could 'voluntarily recycle their SDR holdings to further support low-income countries'. This would open a new channel for rich nations with large reserves to distribute part of their plentiful SDR stocks to poor countries.

The massive increase in SDR reserves – which can be converted into its five constituents: the dollar (42%), euro (31%), renminbi (11%), yen (8%) and sterling (8%) – indirectly boosts the Chinese currency's international reserve role. As Geoffrey Yu of Bank of New York Mellon wrote in July 2020, 'China may have an additional interest in pushing for a general [SDR] issue, as it is a shortcut to a significant de jure nominal increase in the global level of renminbi reserves.'

Janet Yellen, US Treasury secretary, has been a key architect of President Joe Biden's emollient line on the SDR. In a letter to the G20 shortly after her appointment two months ago, she called for more SDR printing in a 'truly collective and multilateral response', urging G20 countries 'to continue to take significant fiscal and financial policy actions.'

The new allocation, the first since 2009, reversed the Trump administration's rejection last year of calls from European and African leaders for the IMF to create additional reserve assets to help emerging economies hit by the pandemic. German Chancellor Angela Merkel and French President Emmanuel Macron joined Ethiopian Prime Minister Abiy Ahmed and South African President Cyril Ramaphosa to urge an immediate decision on SDRs.

The IMF has been swamped by requests for financial assistance by dozens of countries, some of which face cumulative per capita income losses as high as 22% by 2022. With current IMF resources less than $1tn, extra liquidity supply is badly needed.

This latest action underlines changes in the world economy since 2011, the last time emergency SDR use was discussed, at the start of the euro debt crisis. The US administration proposed that the Bundesbank release excess stocks to aid Greece. The Bundesbank opposed this idea strongly. Merkel refused to put pressure on the central bank to change its mind, citing Bundesbank independence introduced under Anglo-American stabilisation measures for post-war Germany.

The SDR – brainchild of then French Finance Minister (and later President) Valéry Giscard d'Estaing – was conceived at a time when many countries, led by France, were converting surplus dollar holdings into gold. Under the Bretton Woods system, which broke down in 1971-73, the dollar would always be 'as good as gold'. However the IMF's unit has taken a long time to gain ground.

In 2009, the United Nations suggested a new SDR-based 'global reserve system' – 'feasible, non-inflationary, and ... easily implemented, including in ways which mitigate the difficulties caused by asymmetric adjustment between surplus and deficit countries.' That same year, Zhou Xiaochuan, governor of the People's Bank of China, proposed that the SDR could become the pivotal international reserve currency, disconnected from individual nations, as 'the light in the tunnel for the reform of the international monetary system'.

Now, as a result of Covid-19, the world's monetary system based on national fiat currencies may be approaching a turning point. With the SDR revival, Zhou's 'light in the tunnel' is shining a little brighter. •

Willem Middelkoop is the author of The Big Reset and the founder of the Dutch-based Commodity Discovery Fund. David Marsh is Chairman of OMFIF.

Biden's impact on ESG investing

Great potential for rapid catch-up on sustainable growth

Elliot Hentov
State Street
Global Advisors

President Joe Biden is keen to make climate change a major theme of his administration, but for financial markets the impact goes well beyond climate. Investors took note of Biden's climate plans well in advance of US elections, with renewables and fossil-free assets outperforming the broader market since last summer's presidential campaign began in earnest. In contrast, markets have paid less attention to social and governance themes in environmental, social and governance investing, particularly around growth prospects for the ESG marketplace in the US.

The Biden administration is certainly eager to promote ESG investing, but there are institutional limits to what can be achieved through direct intervention. Paradoxically, this is one area of financial regulation where the government is likely to pursue a laissez-faire approach. The idea is to remove obstacles to industry trends that are fostering growing ESG integration, building on pension beneficiaries and retail investors' underlying demand for ESG-aware assets.

The Biden administration has already started the rollback of initiatives launched during the Donald Trump years. There had been a push through various regulatory bodies (such as the Department of Labor and Securities and Exchange Commission) to sideline ESG investing by making it harder for asset stewards to incorporate non-financial criteria in their investment selections or in their proxy voting. Other efforts included constraints on bank lending criteria that would have excluded or raised the cost of capital for low-scoring ESG entities.

One of the executive orders issued on Biden's first day explicitly empowered all regulators in his administration to act to ensure alignment with his overall climate agenda, giving legal grounds for imminent changes. However, these measures would only restore conditions back to 2016 rather than improve on them.

The key actions to watch are those that will actively stimulate the market beyond its current state. Direct regulatory intervention will be the least common as many of the core pillars of investment rules are subject to legislation, notably the Employee Retirement Income Security Act, which dictates the governance of most retirement plans.

Regulatory bodies could provide a more lenient interpretation of fiduciaries' range of choices and lessen the regulatory burden across the board. A further regulatory impact could come through areas supporting ESG investments, such as guidelines for the development of the ESG ratings industry to help engender common standards. These changes are meaningful but will only unfold incrementally.

In contrast, Biden is likely to use the presidential pulpit and government influence to encourage a swifter deepening of the ESG marketplace. This could occur through shining favourable light on ESG metrics or by promoting ESG-inclusive disclosures. This is already happening on climate-related issues and is likely to spread beyond this once most of his political appointments are in place.

These efforts could be complemented by joining or co-operating with various international forums, such as the international platform for sustainable finance which includes most members of the Organisation for Economic Co-operation and Development as well as China and India. The Biden administration can directly affect the allocation of federal asset pools (federal retirement pools like Thrift Savings Plan), and therefore provide another tailwind to the growth of ESG investing inside the US.

The reality is that ESG investing is following a powerful structural trend, which was accelerated by the Covid-19 pandemic. 2020 witnessed another boom year for growth in sustainable investing. In the fourth quarter alone, global inflows were up 88% and amounted to $152bn. However, the bulk of that growth remains overwhelmingly in Europe with the US only accounting for about one-eighth of inflows.

This suggests there remains great potential for rapid catch-up that was presumably deterred by the Trump administration. Despite the institutional constraints for major reforms, ESG investing will now enjoy policy and regulatory tailwinds in the US. This could even lead to a temporary mismatch in supply and demand of ESG assets in the US. Corporate pioneers could benefit from lower cost of equity and European funds could attract US inflows on the appeal of their ESG scoring (with the understanding that ESG scores and assessments vary widely).

Like the environment, the climate of finance is changing. While it may seem like a slow evolution, all participants need to adjust as quickly as possible. ●

Elliot Hentov is Head of Policy and Research at State Street Global Advisors.

ESG in the new normal

Covid-19 will create new and exacerbate existing social issues

Mervyn Tang
Fitch Ratings

The Covid-19 pandemic rapidly led to a wave of ratings being downgraded, yet these actions were rarely due to changes in Fitch's assessment of environmental, social and governance factors. The pandemic has undoubtedly had an impact on ESG factors, such as labour management and short-term carbon dioxide emissions. However, the overall impact of ESG factors on credit profiles is limited compared to the myriad factors constraining the liquidity and debt-servicing capacity of entities.

The pandemic does have long-term implications for ESG-related trends, as it has for economies more broadly. Many governments have responded to the pandemic with fiscal stimulus and recovery plans, and some regions, such as the European Union and South Korea, have used this to boost green objectives. Weaker company and government balance sheets may influence ESG-related investments, such as those aimed at facilitating the low-carbon transition or alleviating water scarcity challenges. Fitch identified the low-carbon transition as one of three secular trends influencing corporate credit risks, alongside the digital transformation and supply chain shifts.

Recent supply chain disruptions have also increased scrutiny on how and where goods are produced and traded, including practices related to ESG issues such as deforestation and labour standards.

Greater reporting requirements, as well as improvements in data collection, are increasing the transparency of such issues, and we expect this to increasingly be reflected in the lending and investment decisions of financial institutions.

The pandemic's heavy economic burden on societies is likely to leave persistent social scars, such as greater inequality and poverty, as well as challenges around affordability and access to basic needs. We expect that the societal tensions that stem from these scars, and the policies designed to alleviate them, will lead to new social risks for issuers, as well as exacerbating existing ones.

Fitch believes that the collection of payments from pandemic loans, extended by banks to small businesses under government-guaranteed schemes, is an area where negative reputational risks could materialise if banks are seen as heavy-handed. It is becoming increasingly clear that recovery of the loans may be difficult, given high reported levels of alleged fraudulent applications, loans made to unviable companies and the harsh economic impact on businesses arising from pandemic-related loss of sales, enforced business closures and changes in consumer behaviours.

Growing interest in sustainability issues is driving debate on how such issues should fit into governance frameworks, including the responsibilities of companies to stakeholders other than shareholders, and how short-term financial objectives can be balanced with medium- and long-term goals. The topic will likely grow in prominence as the European Commission presents its upcoming renewed sustainable finance strategy, due in early 2021.

One of the core priorities of the strategy is how the EU can help further embed sustainability into corporate governance frameworks. •

Mervyn Tang is Global Head of ESG Research, Fitch Ratings.

'Recent supply chain disruptions have also increased scrutiny on how and where goods are produced and traded, including practices related to ESG issues such as deforestation and labour standards.'

Custodians need to evolve as assets do

Digitalisation can bring democratisation, lower costs and greater liquidity

Akeel Akhtar and Sid Newby
Citi

To many, digital assets are nothing more than cryptocurrencies. However, central bank digital currencies, stablecoins, security backed tokens, asset backed tokens and non-fungible tokens are also digital assets. Underpinned by blockchain technology, digital assets could transform capital markets by making it easier for investors to trade a wider range of securities and reducing transaction costs. Custodians will play an essential safekeeping role in this new digital securities market, just as they did when dematerialisation took hold almost three decades ago.

So how do digital assets work? Imagine a world where any asset – regardless of whether it is an equity, bond or land title deed – can be digitalised and then fractionalised. Through digitalisation, automation of the investment life cycle can be facilitated by adopting a common infrastructure. This would speed up the entire transaction process and deliver efficiencies. Meanwhile, fractionalisation has the potential to democratise large-value assets, making them more accessible to investors. Not only would this make the entire investment process more inclusive and fair, it may even increase liquidity in alternative assets.

Although cryptocurrencies are the largest digital asset class by market capitalisation today, experts expect digital versions of traditional and alternative assets will soon eclipse them. The banking industry cannot ignore these changes. Custodians have a long track record of embracing disruption, which is why many providers such as Citi are developing ways to safely manage and store the cryptographic keys to these digital assets. As a result, tomorrow's custodians will look after a wider range of assets.

There are complex challenges to overcome before digital assets are fully adopted. As new marketplaces and assets emerge, there is a risk that technologies, processes and regulatory oversight fragment. A few regulators – including those in Germany and Luxembourg – are looking to simplify and clarify the rules around new digital assets.

The technology underpinning these new instruments is developing quickly and it is vital the industry keeps up with this pace of change. Banks need to ensure they fully integrate these new technologies with legacy operations, as this new ecosystem will operate alongside existing markets and assets for years to come.

Digitalisation of assets, if successful, could have a revolutionary impact on investment behaviour. However, for digital assets to become ubiquitous, many hurdles will need to be overcome. As investor appetite grows for digital assets, leading banks such as Citi are responding by building digital asset custody solutions and other related services in collaboration with clients. A robust custody framework will be vital if this nascent market is to thrive. ●

Akeel Akhtar is Vice-President, EMEA Public Sector Group at Citi
Sid Newby is Head of EMEA Asset Owners Sales at Citi

'Although cryptocurrencies are the largest digital asset class by market capitalisation today, experts expect digital versions of traditional and alternative assets will soon eclipse them.'

Building back better

The Next Generation EU programme will launch its first bond issue in June and bring in a new era for European capital markets. Raising €800bn over five years to help the EU recover and build back better from Covid-19, some 30% of its borrowing will be in green bonds. What will be the lasting impact of the Next Generation EU programme?

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

Accelerate the EU's economic recovery from Covid

39%

Too little too late

26%

Transform Europe's sustainable capital markets

17%

Waste the proceeds and the opportunity

4%

Other

14%

While the Next Generation EU programme will doubtless accelerate the European Union's recovery from Covid, staggering amounts of debt are being issued to support growth, so the scale of the programme is not particularly distinctive. Nor will its contribution to the development of European sustainable capital markets be overwhelming. The region's investment management companies and investment banks have already established a global lead in this field. However, it does provide the opportunity for Europe to prove its cohesiveness and ability to act beyond national interests.

Colin Robertson, SW1 Consulting

The programme will accelerate the EU's economic recovery and transform Europe's sustainable capital markets. It lays the foundation of a modern and more sustainable Europe and gives hope for the post-covid Europe to be greener, more digital and more resilient.

Hemraz Jankee, formerly Bank of Mauritius

It could further open the way to a multi-tiered political integration, not necessarily with 27 member states.

Antonio Armellini, AIICP Italy-India Association

The injection of funds will be crucial to sustain the recovery in the weakest country of the EU. But, more crucially, the attached conditionality will force the government to adopt necessary a necessary package of structural reforms, which successive governments have resisted for decades.

Fabio Scacciavillani, NuVerse Advisors

It will legitimise the EU's willingness and capacity to act, including through new sources of funding when a sizable problem affects many member states

Philippe Lagayette, formerly Banque de France

In terms of timing, it's a bit like the launch of the euro. It will evolve slowly, over the course of ten years. During this period, it will lay foundations for a European financial system that is less centred on banks. But there are several other policy developments which will be needed to achieve this.

Stewart Fleming, University of Oxford

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Steve Hanke
The Johns Hopkins University

Hans-Olaf Henkel
University of Mannheim

Mumtaz Khan
Middle East & Asia Capital Partners

Joel Kibazo
JK Associates

Jürgen Krönig
Die Zeit

Oscar Lewisohn
Soditic

Boyd McCleary
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Luiz Eduardo Melin
International Economic Synergies

Willem Middelkoop
Commodity Discovery Fund

Célestin Monga
African Development Bank

Danny Quah
Lee Kuan Yew School of Public Policy

Takuji Tanaka
Japan Finance Ministry

Daniel Titelman
ECLAC

Pasquale Urselli
Mazars

Paul van Seters
Tilburg University

POLITICAL ECONOMY

Antonio Armellini
former ambassador, OSCE

Frits Bolkestein
formerly European Commission

Laurens Jan Brinkhorst
University of Leiden

Peter Bruce
Business Day

Jenny Corbett
Australia National University

Maria Antonieta Del Tedesco Lins
University of São Paulo

Hans Eichel
former German minister of finance

Jonathan Fenby
TS Lombard

Jeffry Frieden
Harvard University

Elliot Hentov
State Street Global Advisors

Roel Janssen
NRC Handelsblad

Yosuke Kawakami
formerly Japanese Ministry of Finance

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

NETWORK

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David Badham
Franco Bassanini
Eduardo Borensztein
Consuelo Brooke
Colin Budd
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David Cameron
Forrest Capie
Stefano Carcascio
Desmond Cecil
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