Covid, climate, cars, currencies and clearing

In the pick of this week's output from ING Research, we look at how Europe is getting its act together on Covid-19. There's the climate action-angle and the CEE auto-makers' angle. We have news that international investors may soon get more access to Turkish debt markets and we look at the challenges of digital currencies for commercial banks

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Why Europe may finally be getting its act together over Covid-19

It looks as if Europe is finally getting its act together over the coronavirus crisis. ING's Carsten Brzeski says we've seen four remarkable events over the last few weeks, not least the proposal for the European recovery fund, backed by both France and Germany. We also finally have a pan-European fiscal response and German action here, says Carsten, is remarkable. All this combined could lead to more solidarity and integration in the eurozone.

Watch video

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Article | 15 June 2020 New Horizons Hub

Will Climate Action Survive Covid-19?

A sustainable recovery needs to be more than just ‘green’

A sustainable recovery needs to be more than just ‘green’

The economic calamity triggered by the Covid-19 pandemic leads many to conclude that action on climate change will have to wait. Talk of a ‘green recovery’ is in danger of remaining just talk, as the urgent priority of saving lives and livelihoods consumes policy-makers’ attention.

This is troubling, because climate change is ultimately a much bigger problem than the pandemic. At least with the virus, there’s the hope for a vaccine, perhaps within a year or two. Tackling the existential threat of climate change is a more complex, longer-term challenge.

So how can climate action avoid becoming another casualty of Covid-19? It will have to bind itself into the immediate worries about jobs. A green recovery is only likely to take off as part of a broader sustainable recovery that supports the needs of people as well as the planet. And for such a recovery to be both economically and politically sustainable, it will have to avoid polarised approaches to society and business.

In many ways, climate action advocates are encouraged by the immediate lessons of the pandemic. There is newfound respect for scientists, whose warnings about the threat of pandemics were ignored by many governments. This should reinforce attention on the compelling scientific evidence on the climate change challenge. The heavy toll exacted on countries that failed to react quickly to the pandemic has alerted everyone to the power of exponential growth. Our lack of preparedness will now fuel a craving for safety, security and resilience in the face of future threats.

We are now all too aware of the fragility of modern life, and of our mutual interdependence. Enforced social distancing has made us acutely conscious of our social nature and how we are linked into local as well as global networks. The sudden emergence of neighbourliness and mutual aid groups shows our capacity for altruistic behaviour. Our willingness to take rapid collective action, make sacrifices, and change norms shows a remarkable capacity to change. We have also been reminded of our connections with nature.

These lessons show how we could rise to the challenge of climate change. But will we? The pandemic has inflicted enormous damage not just on lives and our physical and mental well-being, but also on our livelihoods and financial well-being. Mass unemployment and bankruptcies will dominate the agenda in many countries even beyond the end of the pandemic.

The Pandemic Pushback

Already, many national policymakers have pushed back against the idea of making climate action a priority in the recovery from the pandemic. With the focus on restoring income and jobs, the green credentials of the businesses being rescued are being largely overlooked. In the US, efforts by Democrats to add climate change provisions into the US stimulus bill failed, and the Trump Administration announced a rolling back of automobile fuel efficiency standards. Meanwhile, China delayed its automobile emissions standards and in Europe some countries are expressing caution about how quickly to pursue the EU's green agenda. None of this points to progress ahead of the global COP 26 climate talks, despite them having been postponed until next year.

Meanwhile, the collapse in oil prices and corporate profits have weakened the incentives and wherewithal to invest in the green energy transition. With lower income groups under particular pressure in the pandemic-induced recession, there is resistance to the idea of stepping up spending on climate action or taxing carbon and energy. 'Brown' jobs are seen as better than no jobs.

Some climate action advocates are heartened by the fact that lockdowns and social distancing have dramatically reduced travel and energy-intensive forms of consumption, with visible benefits in the form of a sudden drop in pollution. Yet there is room to doubt how sticky these behaviour changes will be. While people can recognise the local benefits of changing their behaviour to mitigate the pandemic, for most climate change is a less immediate and evident danger.

Indeed, it could be a different story once the pandemic is over. People may crave a 'return to normal'. Success in developing a vaccine may facilitate this, by eliminating the need for social distancing. And in any case, some adopted behaviours may not be climate friendly. Some people may be reluctant to return to using public transport and use cars instead. They may also want lower density housing and offices, which might support the demand for real estate.

Similarly, some new corporate behaviours might also work against the drive to reduce emissions of greenhouse gases. The disruption of the pandemic, which highlighted the world's reliance on China's manufacturing, is likely to cause many businesses to seek to increase their resilience and shorten supply chains. This may be at the expense of efficiency and lead to higher resource use.

The risks of hyper-connectivity revealed by the pandemic have also been seized upon by populist politicians to justify their nationalist agendas. This poses perhaps the most serious threat to securing the global co-operation needed to deliver climate action. The idea that self-reliance is critical has been given further momentum by the fact that even mainstream democratic governments have joined populists in seeking national solutions to the pandemic, albeit partly because health is largely the preserve of national policy.

Right-wing populists, who are typically climate change sceptics, have sought to deflect the blame for the pandemic onto foreigners. While some of those in power have faced criticism for their handling of the pandemic, the fact that it has amplified inequality may feed further polarisation and help other populists to gather support.

Particularly troubling is the blame game that has broken out between the US and China. While this is not yet a new Cold War, it challenges the prospects for global agreement on climate action. Moreover, the threat of further tension with China over trade also threatens the supply of renewable energy equipment and raw materials, which it dominates.

Why all is not lost for climate action

Yet despite these formidable headwinds, all is not lost for advocates of climate action. Before the pandemic, climate change was at the very top of the global policy agenda. Indeed, given the need for ongoing stimulus to sustain recovery, there is the opportunity for pre-existing climate action plans to be accelerated and repurposed to this end. A prime example would be the EU's Green New Deal. The UN's disaster recovery slogan "Build Back Better" has already been co-opted to this cause.

One factor which may help the green cause is that sceptical populist regimes are facing criticism for slow or disorganised responses to the pandemic. They may try to spin their way out of blame, but the relative success of other regimes will be hard to suppress.

The US is shaping up as a crucial battleground. While the final reckoning on the pandemic is some way off, it is already clear that President Trump has not enjoyed the same popularity bounce that other leaders have. Indeed, following public anger over his response to widespread protests over police violence, polls show him falling further behind his Democratic challenger Joe Biden in the run-up to the elections in November. Were Biden to win, he has pledged that the US would re-join the Paris climate agreement and commit to net zero greenhouse-gas emissions by 2050. And if Democrats retake the Senate, too, some features of the Green New Deal could even be on the table.

At the global level, the ending of the pandemic may also present a window of opportunity to mobilise popular support for action on climate change. Governments have shown their ability to take radical action and enforce drastic changes in social behaviour. This will give them credibility as agents of change. On top of this, success in the global effort to produce a vaccine would be a major win for cross-border cooperation.

While the sense of solidarity engendered by the fight against the pandemic may be frayed by its unequal impact, the resulting sense of injustice could be channelled into climate activism. This possibility is reinforced by the damage inflicted on the livelihoods of the young, who tend to be more concerned about green issues.

Moreover, the longer the pandemic persists, the more the new climate-friendly behaviours are likely to become embedded. Surveys are already starting to confirm the psychologists' beliefs that repetition is turning them into habits. The step shift towards digital interaction and commerce may therefore permanently lower the growth in travel and resource use. While there will still be craving for physical interaction, preferences may be tilted to fewer but higher quality interactions.

The grass roots support for climate action would also be given added momentum if the pandemic is accompanied, or quickly followed, by a further round of exceptional climate events such as storms, fires and floods. This would snap attention back to the climate problem, particularly as it would heap more pressure on already-stretched emergency response resources.

Yet we cannot escape the fact that the appetite for climate action will be largely dictated by the economic hangover from the pandemic. Here, the fact that our more digitalised lifestyles are cheaper is encouraging. Less commuting, travel, and dining out will bring welcome relief to household budgets. Hard-pressed and debt-burdened businesses will also gratefully embrace any cost savings that stem from digitalisation and remote working, and some of this will feed through to the benefit of consumers.

But this brings us back to the most pressing challenge posed by the pandemic legacy. Digitalisation and corporate cost-cutting may translate into further job losses that make it all the harder to reduce the current spike in unemployment.

To gain popular support, the narrative needs to shift from a 'green recovery' to a broader 'sustainable recovery', one with the welfare of people at its heart. After all, climate action is but one of the UN's 17 Sustainable Development Goals (SDGs), and it's not for nothing that people come first in the 'triple bottom line' of people, planet and profits. So amid the economic hardship that will flow from the pandemic, income and jobs will clearly be the top priority.

Since the pandemic is hitting lower income groups particularly hard, a recovery in the labour market will serve to reduce inequality. But to be truly sustainable, politically as well as economically, the recovery will also have to develop broad support across society and business.

This is a particular challenge in societies that are already highly polarised, not just politically, between left and right, but also culturally between "open" and "closed" identities. Here the US is again critical. The risk is that strongly Progressive Democrat policies might jeopardise the growing support from moderate Republicans for climate action. This could ultimately lead to a renewed backlash from the populist right.

This means seeking a smart suite of policies balancing the green gains from investment and subsidies with the political pains from tax and regulation. Those pains will need to be distributed in a socially tolerable manner. As France's experience has shown, a regressive tax that hits rural commuters or other politically influential constituencies will face strong resistance.

To some extent the challenge can be mitigated by central banks monetising the pandemic-induced spike in public and private borrowing. But this will still leave a long shadow of debt to be worked off in a way that is acceptable across social groups and across time. Thankfully, the likelihood that interest rates will remain low means that there is no need to hurry.

The pursuit of a sustainable recovery calls for a balanced partnership between government and business. Climate action that leans too heavily on 'big government' solutions of public investment, progressive taxation and regulation would undermine the valuable contribution that could come from private investment, innovation and market mechanisms. Moreover, demonising carbon-heavy 'brown business overlooks the important role of the fossil fuel and nuclear industries in the multi-decade transition to the net zero emissions world. This means that some state support may be needed to deliver the required investment.

Fortunately, even prior to the pandemic, the idea of sustainability and inclusive growth was gaining ground in business circles. Companies and investors have increasingly championed a shift from the model of shareholder capitalism to one of stakeholder capitalism, embracing broader sustainability goals. Investors will have noted that companies leading in this direction have outperformed during the pandemic.

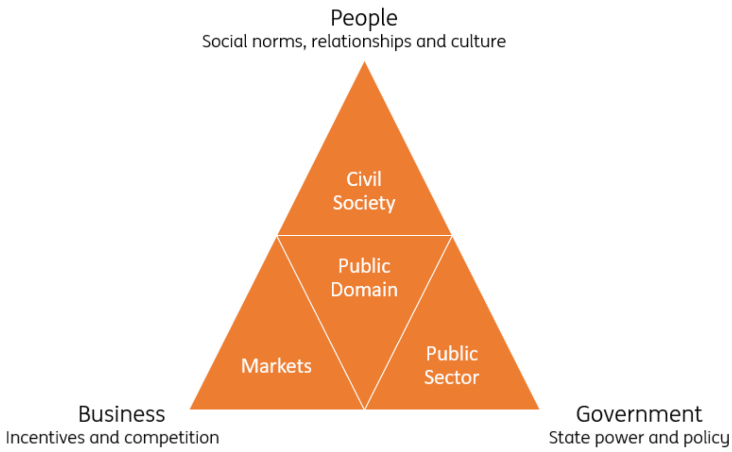
Nevertheless, the early movers in business still face a collective action problem. While investor attitudes are starting to change more rapidly, most shareholders remain focused on short term returns, particularly after the pandemic-induced losses. This means that businesses stressing long-term sustainability risk punishment in the financial markets. Governments and regulators will need to recraft the rules of the game if they wish to accelerate the change.

The emergence from the pandemic provides governments with an historic opportunity to institutionalise the shift towards sustainable business practices. It is true that in the rush to keep businesses afloat many governments have so far been reluctant to attach 'green strings' to their emergency funding and loans. But there are likely to be more opportunities to do so before the pandemic is behind us. The health emergency has led to a collapse in carbon-heavy travel and transport activity. This means that whole sectors such as airlines face existential threats, which gives governments enormous leverage to attach conditions to their support[1].

Indeed, with so much in flux and the previously unthinkable turning suddenly into reality, there is scope for radical legal and institutional changes to embed stakeholder capitalism. Steps could include broadening board representation to workers and other stakeholders, more active support of small business and start-ups, and cultivating more social business models such as local co-operatives. Such steps would also develop the engagement of civil society.

1. It is worth noting that the spotlight on aviation rather overlooks the point that bigger and more cost-effective ways of reducing fossil fuel emissions could be found in other sectors such as manufacturing, power systems and road transport.

Sustainable Recovery Rests on Three Pillars



Source: ING

Having protected the downside for business, governments, on behalf of society, are also in a strong position to claim equity participation in the potential profits that will flow in recovery. This would not only avoid overburdening business with debt but also give governments the opportunity to spread the returns on capital to taxpayers and workers. In some cases, governments may be forced to nationalise failing companies or restructure whole sectors.

Moreover, governments have the opportunity to drive private as well as public investment to meet their sustainability goals. Private investment can be incentivised by setting or accelerating specific long-term deadlines for phasing out activities that generate high levels of emissions. Public investment and targeted subsidies and grants can have a catalytic effect. A recent survey of 231 policymakers and economists identified a range of attractive job-creating green investments, including clean physical infrastructure and building efficiency retrofits. And to boot, sustained low interest rates will make funding these investments more affordable.

The accelerated digitalisation of economic activity enforced by the pandemic lockdowns and travel restrictions is likely to be sustained. Like renewable energy, the marginal costs of digital technology are low and falling rapidly, so the constraint on their adoption lies more on the upfront investment in infrastructure and capacity. Government incentives to foster such investment will therefore have multiple benefits in terms of stimulating jobs, accelerating technical progress and garnering the climate benefits of the shift from physical to digital activity.

That said, while the rollout of the new technologies will create new jobs, it will also destroy old ones. Supporting the displaced workers, and funding the investment, will add more pressure on public finances. So a sustainable recovery will also need a new societal settlement on tax burdens. There is likely to be irresistible pressure to increase taxes on the digital winners who would otherwise scoop a disproportionate share of the gains from accelerating digitalisation. Moreover, the fact that the marginal costs of the new digital products and services are falling creates the space for raising taxes without putting upward pressure on consumer prices.

Given the dominance of US and Chinese tech giants, digital taxes will continue to be a source of geopolitical friction. Nevertheless, the tech companies are tuning into the fact that public tolerance for their 'winner takes all' economics is crumbling. Indeed, some tech leaders have even joined the chorus calling for radical support of displaced workers by more evenly sharing the gains of digitalisation through ideas such as universal basic incomes, universal basic dividends or state-subsidised or guaranteed jobs.

In a similar fashion, the recent collapse in energy prices presents a golden opportunity to accelerate progress on carbon taxes and subsidies. Raising taxes and cutting subsidies on carbon-intensive activities is one green policy shift that enjoys near universal support among economists. Crucially, it is enjoying growing support across the political spectrum and even from fossil fuel producers. Even in the US, where climate change scepticism has been prevalent, an increasing number of Republicans are endorsing the use of the price mechanism.

By directly incentivising consumers and producers to curb emissions, economists see carbon taxation (or trading of emissions permits) as the most efficient way of addressing the problem. And by acting while energy prices and the general level of inflation are low, the burden will appear less onerous. In any case, the obvious way to make higher and broader carbon taxation popularly acceptable is to give the revenues back to people via general tax cuts or flat rate payments – so-called 'carbon dividends'.

One such proposal in the US, the Baker Shultz carbon dividends plan, which involves CO2 emissions taxes beginning at $43/ton, would result in a family of four each receiving $2,000 a year. According to US Treasury calculations, the lowest 10% of earners would see their net incomes rise by 8%, while the highest 10% would see a net reduction of only 1%. This is even before factoring in the benefits of reduced pollution, traffic, accidents, illness, extreme weather events, and dependence on energy imports.

Domestic fairness and support aside, another issue is how to achieve cross border fairness and co-ordination on increasing carbon taxation. There is a risk that some countries will try to gain competitive advantage by not imposing higher carbon taxes and free-ride on the efforts of others to reduce emissions.

One way of addressing this is to impose carbon border taxes on imports from countries that do not tax to the same level. That could encourage some countries to raise their own taxes to secure the revenue, but it might also unfairly hit poorer countries that have low emissions. Raghuram Rajan advocates tackling this with a redistributive plan for a global carbon reduction incentive. This would mean that the more a country emitted above the per capita world average, the more it would pay into an incentive fund to distribute to below-average emitters. He suggested that the US could fund its contribution by modifying the Baker Schultz plan to divert some of its carbon dividends from richer households.

More generally, financing the recovery in a sustainable, more socially inclusive way will involve a broader shift of the tax burden away from labour income, at least for the lower and middle income groups. Aside from higher taxes on digital activities and carbon emissions, a creative search is needed. Longstanding targets for more progressive taxes on profits, wealth, property, and land will doubtless be in the frame.

But the green agenda may also be served by higher taxes on the consumption of other resources. The developed world's addiction to more 'stuff' is surely ready to be addressed. A good example would be taxes to reverse the upward trend in the size of cars and SUVs, a trend which is strangely at odds with the fact that the average vehicle occupancy in the developed world is around 1.5.

A window of opportunity for a full spectrum policy shift

Radical tax reform is part of the full spectrum policy shift needed for a broadly sustainable recovery. This shift would lead to a radically different world. How far will we move in this direction? This is not yet clear, since it will depend on the final reckoning on the pandemic and its global political fallout. What is clear is that the increasingly polarised nature of politics, not least in the US, points to a binary outcome. And it may soon become clear whether or not we will see a leap forward before the pre-pandemic behaviours reassert themselves. With the US elections in November, and a vaccine hoped for in the months after, we will see if the window of opportunity opens up.

For governments, the window of opportunity on climate action reflects the popular recognition of the importance of competent government, not just in health, but in mobilising business and society. This is not so much about 'big government' but 'smart government'. So while regulation has its place at a strategic level, one of the lessons of the pandemic is the agility that came from sweeping away unnecessary bureaucracy. Loose monetary policy and low interest rates also open the window for funding that a sustainable recovery calls for.

Governments also have a window of opportunity to develop a new social contract with business. They could leverage dependence of businesses on state support to enforce change towards sustainability. With so much in flux and the previously unthinkable turning suddenly into reality they could institutionalise the growing willingness of business to embrace stakeholder capitalism. They could also wean businesses off debt in favour of broader equity participation.

The shift towards stakeholder capitalism would also complement the sustained mobilisation of civil society. The newfound recognition of the vital role of the service sector, small businesses and start-ups in generating jobs and serving local communities needs to be embraced by both government and big business. Local communities, co-operatives and social organisations could all support a grass roots shift towards sustainable growth and climate activism.

Yet markets and market mechanisms are also part of the window of opportunity for a sustainable recovery. Radical changes to taxes and subsidies, combined with new regulatory frameworks for markets, could incentivise rapid change in private consumption and investment. Tumbling prices and the acceleration in the adoption of new technology may sustain a green-friendly digitalisation of the economy and provide an opportunity to step up taxes on digital services and supernormal profits.

Likewise, low energy prices offer a chance to kickstart the shift towards taxing carbon from taxing labour. The revenues from taxing carbon emissions, and the use of other resources, could be used to reduce taxes on income and employment or introduce universal basic incomes and dividends.

In these ways, climate action does not have to fall victim to the colossal economic damage caused by the Covid-19 pandemic. Indeed, there is a unique opportunity for it to form part of a broader sustainable recovery that supports the needs of people as well as the planet. For true sustainability will ultimately depend on healing divisions in the economy, politics, society and business.

A shorter version of this report was published by Project Syndicate ***under the title "A Sustainable Recovery Must Be More Than Green".***

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It's not easy being green

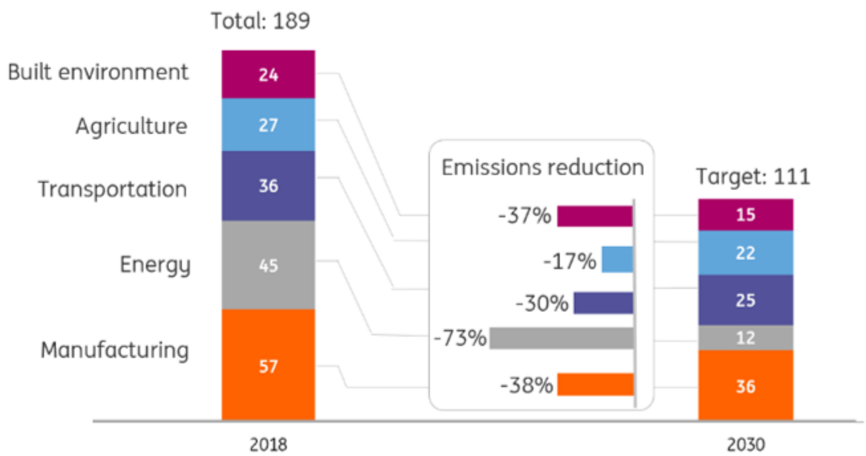
The investment and capital challenges faced by Dutch network operators

Source: istock

Dutch energy transition and the main goals

The Netherlands has been slow to adopt an energy transition programme compared to other European countries. The Climate Plan, released by the government in late-June 2019, marked a clear turning point as it aims to reduce Dutch carbon emissions by at least 49% by 2030 compared to 1990. This ambition would turn the country from laggard to frontrunner. Energy transition plays a pivotal role as emissions from the energy sector need to be reduced by as much as 73% by 2030.

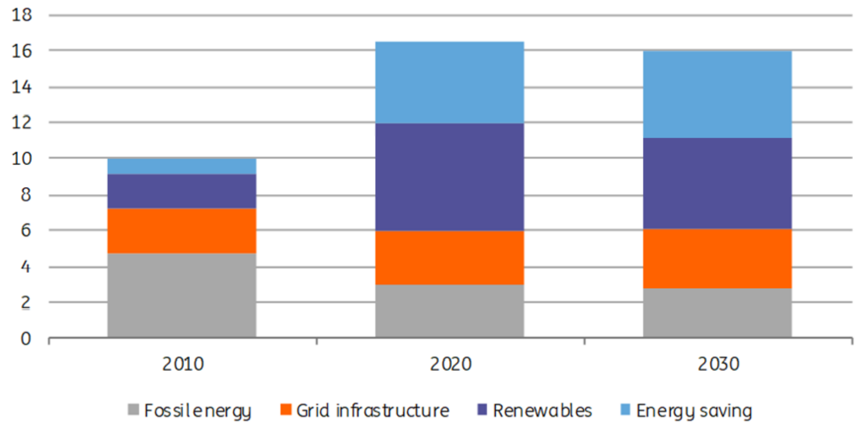
Dutch energy transition plan: Co2 emission reduction targets



Source: CBS, CPB, RIVM, ING

The Dutch government aims to phase out coal in its energy mix by 2030 and natural gas by 2050 in order to meet the targets. It also calls for a strong increase in renewables. We forecast this share to reach 25% in 2020 with the number expected to be 74% in 2030.

Investments in the Dutch energy system (€bn/year)



Source: PBL, ING

Implications for Dutch gas and electricity grid operators

The transformation to a low carbon economy requires increasing investments in the energy system from around €10bn a year in 2010 to an estimated €16bn a year in the period 2020-2030. Total investments in solar panels and wind farms will continue to fall as the assets become cheaper and cheaper.

DSOs will spend between €700m and €900m in 2020

On the other hand, investments in grids will continue to rise in order to accommodate the increasing share of renewables coming into the Dutch network systems. For the Transmission System Operators (TSOs) and the Distribution System Operators (DSOs), the change to a low carbon economy translates into exponential capital expenditure plans.

The call for capital injections and a new regulatory method

Already, a number of Dutch network operators cannot cover operating costs and required investments by the cash flows they generate. Some network operators want their shareholders to inject new capital. While this can provide temporary relief, it needs to come with higher tariffs from the Dutch regulator ACM in order to finance investments with operating cash flows.

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Report | 18 June 2020

CEE automotive industry: Accelerating challenges

The global automotive sector will be significantly affected by the Covid-19 crisis and Central and Eastern Europe is no exception, as some countries in the region are heavily dependent on the industry

Source: Shutterstock

Although some countries in the CEE region have introduced car subsidies (even before the Covid-19 outbreak), what matters more for the region, which exports a large part of its auto production, is the recent EU/German scrappage scheme. But given its focus on electric cars subsidies, it will provide only limited help to the CEE automotive sector, as electric cars are only gradually being produced there. Benefits to the region coming from potential supply chain disruptions seem less clear and we do not see any strong evidence for that just yet. As such, the Covid-19 crisis might accelerate challenges for the sector, which were already apparent before the coronavirus outbreak.

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Article | 19 June 2020 Turkey

Euroclear: A possible turning point for Turkey

International investors could soon get increased access to Turkey's debt market after a deal between Brussel's based Euroclear Bank and the Finance Ministry. It's an important move after years of concern that Turkey was moving away from international markets

It's taken eight years to get here

After eight years of talks, Euroclear Bank, an International Central Securities Depository (ICSD) and the Ministry of Treasury and Finance have reached a deal, with the imminent launch of a Euroclearable link to enable international investors to access to the domestic debt market. The deal should provide foreign investors full access to the local market in a more secure and standardised way. The Treasury will have enhanced access to wider liquidity pools. There's also the potential for a reduction in the overall volatility of borrowing costs, as we've seen in other cases. Most importantly, after years of concerns that Turkey might disengage from international markets, this deal could mark a turning point and prove to be quite the opposite.

Background to the agreement

Admittedly, back in May, we weren't expecting this deal because of policies aimed at avoiding or curbing additional pressure on the Turkish lira (TRY).

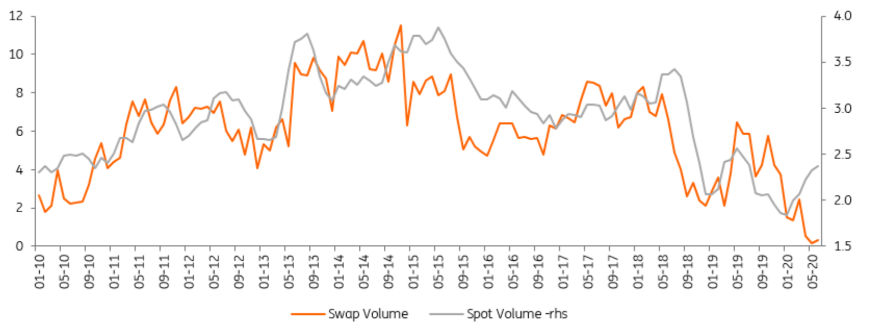
- In mid-April, the BRSA (Banking Regulation and Supervision Agency) decided that derivative transactions with foreign counterparties, where at the initial date local banks pay TRY and receive FX, should not exceed 1% of the bank capital, down from 10% limit, set earlier.
- In early May, BRSA also lowered the limit to 0.5% of banks' equity for TRY depo, repo transactions, and credits with foreign financial institutions.

These policy moves have effectively pulled the volume of swap transactions between local banks and foreign counterparts significantly downwards, appreciably shallowing the market.

As a response, Clearstream Banking said that transactions in TRY over its Bridge settlement platform can no longer be settled under satisfactory conditions due to liquidity restrictions on the currency.

Consequently, the BRSA exempted Euroclear Bank and Clearstream Banking from these limits on banks' TRY transactions with foreign financial institutions, citing objectives of protecting the clearing of TRY-denominated bonds and Sukuk, and ensuring Turkish lira securities are traded efficiently. Finally, Turkey reached a deal with Euroclear in the past few days.

Volume of FX transactions with customers abroad (monthly avg, US$bn)



Source: CBT, ING

The Government's motives for the deal

With significant improvement in financial infrastructure and adjustments in the legal framework, Russia, Peru, Chile, Malaysia and Poland have achieved Euroclearability status in recent years, though there are a number of countries in emerging markets, including Brazil, Indonesia, India, and Philippines etc., that do not sufficiently meet all the requirements to be Euroclearable. Strong client interest with reform-driven EM stories has been one of the major drivers for them to join Clearstream.

In the Turkish case, key drivers according to the Treasury and Finance Minister, Berat Albayrak, are:

1) To further align the capital market framework with globally recognised standards: The government has always had an objective of deepening capital markets via diversification of financial instruments and raising more funds through alternative and less costly methods. In this regard, we have seen some efforts to improve capital markets including a new capital markets law, new products such as the issuance of Islamic bonds, the establishment of ETFs etc. So, the agreement is seen as another step in this direction.

2) Support to the Istanbul Financial Center objective: It is widely acknowledged that an international financial centre should offer deep liquid and sophisticated capital markets and competitive regulator regimes with foreign investment and offshore business flow. So, Minister Albayrak expects contribution from the deal here.

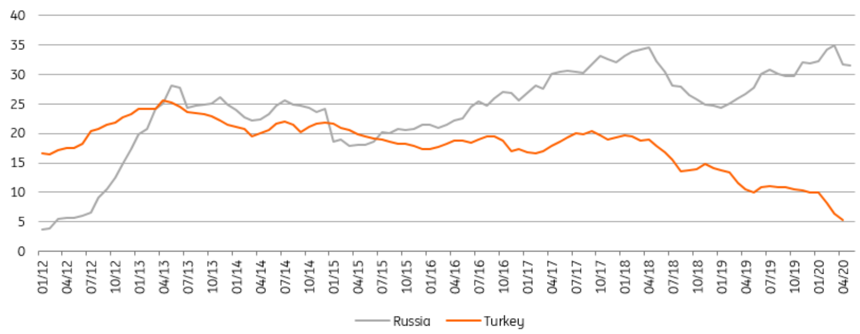
3) Wider foreign access to the local market: For the government, being able to tap into the liquidity provided by international investors through Euroclear is important for the continued development of our local debt markets. The move should also contribute to the local market outlook, as a safe place for bond investments in times of risk aversion.

1 Turkey can potentially benefit in a number of ways

It can attract more foreign investors to invest in domestic markets. Turkey has been under pressure with greater volatility in core economic measures (i.e. inflation, interest rates etc.), while downgrades by rating agencies in the last few years have contributed to those stability concerns. Accordingly, we have seen a significant decline in foreigners' market share in domestic bonds from almost more than one-fourth of the stock in early 2013 to slightly above 5%, the lowest of the current series which began in 2005.

Early experience from other countries shows that Euroclearability can be a booster to foreign portfolio flows. As an example, Russia signed an agreement on October 2012, and OFZ became fully Euroclearable in February 2013. Since late 2012, the share of non-resident investors has more than doubled with strong flows. This is also the case for other countries including Chile, Poland and so on.

Nonresidents' share in domestic debt stock (%)

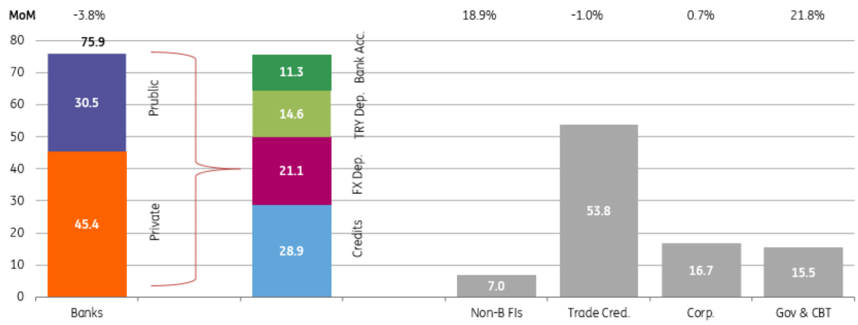


Source: ING

It should be noted that the deal is unlikely to create a direct imminent impact given risk anticipation from high external financing requirements compared with other EM peers, a recent decline in reserves and continuing geopolitical fragilities. This has already been reflected on overall capital flows to Turkey, barely positive on a 12M rolling basis in recent months.

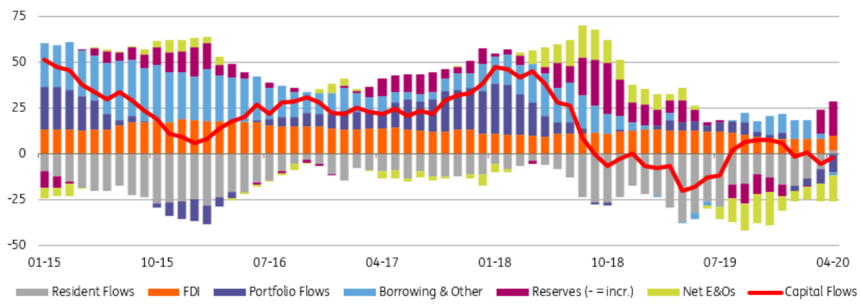
Any support from the deal to portfolio flows would be a plus for Turkey. However, for the benefits to materialise, foreign investors will also be looking for signs of stabilisation in the external financing (e.g. successful rollovers of syndicated loans, FX reserves), funding market and the TRY as Euroclearability by itself can be considered as a necessary but not sufficient step to broaden the investor base or to see a reversal in the decrease in foreign investor involvement.

Short term external liabilities (US$bn, as of March 2020)



Source: CBT, ING

Breakdown of C/A Financing (12M Rolling, US$bn)



Source: CBT, ING

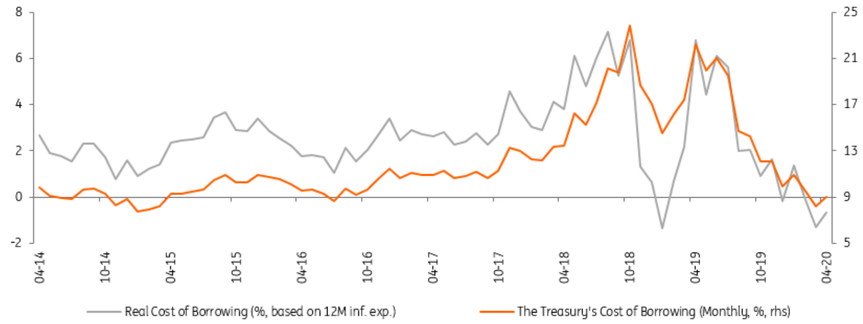
2 Supportive impact on borrowing costs

Additionally, Turkey can benefit from the supportive impact on borrowing costs: Assuming a more diverse and stable foreign investor base following the Euroclearability that also allows local issuers to deal with a wide range of international investors, borrowing costs' volatility should come down and reduce vulnerability to fluctuations in capital flows.

Turkey still enjoys a low public debt-to-GDP ratio relative to its peers, providing room to resort to more fiscal stimulus in times of strains, just look at the currency shock on 18 August and, of course, the Covid-19 pandemic. However, in the short-term, liquidity could be an issue due to increasing fiscal funding needs. The deficit is expected to exceed 5% of GDP in 2020 and public debt-to GDP is around 35% as of April 2020.

Given this backdrop, any support from the deal for more flexible and effective debt and fiscal management should be a plus for policymakers. In this regard, the Treasury can also have the flexibility to reduce reliance on foreign debt capital markets (USD/EUR external issuances) on the back of a broader investor base in local currency credit. Moreover, this could also help extend the maturity profile of the TURKGB curve. All of this would ease financing pressure and, over time, reduce concerns on FX external debt.

Borrowing cost of the Treasury



Source: Ministry of Treasury and Finance, TurkStat, ING

3 The country's international profile

A third benefit would be to positively contribute to Turkey's international profile: Increasing government activity with frequent changes to rules and regulations, reflecting greater volatility in the business environment has also affected foreign investors, increasing concerns about the possibility of capital controls, among others. The deal, likely supportive for the liquidity of domestic markets and financial stability, should be a signal of the government's interest to attract portfolio flows and commitment to free movements of capital.

Overall, the Euroclear link will be in place by mid-July meaning that it will apparently be a more cost-effective, efficient and simple alternative to the Delivery versus Payment (DvP) through local custody accounts. This will facilitate access to the domestic TURKGB market within a more secure and standardised way for non-resident investors as well as allowing the Treasury enhanced access to wider liquidity pools. But the crucial impact can be on Turkey's international profile, indicative of Turkish policymakers' interest to accelerate capital flows.

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Opinion | 17 June 2020

Why I'm deeply sceptical about deeply negative rates

In a recent THINK Outside article, US economist Kenneth Rogoff made the case for deeply negative interest rates. According to ING's Rob Carnell, his reasoning is deeply flawed

Given that we work in the realm of the dismal science, where nothing is certain, and everything open to question and debate, a useful attribute when writing, is a large dose of humility, and a healthy respect for alternative views. Thus, when reading an article, even if you don't agree with the content, you can at least engage intellectually with the author at the same level.

Kenneth Rogoff's "The case for deeply negative interest rates" which is published as one of our Think Outside articles, and originally written for Project syndicate, is light on these attributes. And that doesn't help the reader to entertain his basic premise, which is that substantially negative interest rates are the best way to drag the global economy out of the doldrums.

This is an opinion that I do not share. The alternative viewpoint, that such policies provide a mixture of positive and negative impacts, and that as rates fall, the negatives begin to outweigh the positives, is not a dogmatic standpoint, but one that has arisen from observation of low and negative rates in multiple economies over recent years. It is also supported empirically (for example, in this study from Bath University) though I concede that the empirical evidence is mixed. I will return to this later.

Here is the article summary as a backdrop for our subsequent critique: "*Only monetary policy addresses credit throughout the economy. Until inflation and real interest rates rise from the grave, only a policy of effective deep negative interest rates, backed up by measures to prevent cash hoarding by financial firms, can do the job*".

And immediately alarm bells start ringing as in just two sentences all other policy options and opinions are dismissed while promoting substantial negative rate cuts as the only response worth considering.

This isn't a great start in my opinion (others may disagree), but let's take a closer look at some of the subsequent comments, and follow them with some remarks of our own.

1 "Only monetary policy addresses credit throughout the economy"

That may well be the case. But equally, there have been times in recent economic history where monetary policy has been utterly impotent. For example when policy rates failed to have any impact on the rest of the yield curve, as we experienced for some time during the so-called bond yield conundrum. Sometimes, policies just don't behave in practice the way the textbooks say they should, and that is usually not because the theory is wrong, but because textbooks oversimplify the reaction functions. Such deviations from expected outcomes are, in my view, much more likely when policies deviate substantially from their normal operating ranges, for example, substantially negative policy rates.

2 "Negative rates would lift many firms, states and cities from default"

I see what is being implied, but is there perhaps a confusion between debt-service and debt repayment here? Negative rates can help with the former, but if you can't pay the principal, it won't help these entities much. Greece's debt crisis is a good example of these differences.

3 "If done correctly – and recent empirical evidence increasingly supports this – negative rates would operate similarly to normal monetary policy"

While empirical evidence is mentioned to support the negative interest rate proposition, the article cites just one recent piece. I've done a bit of google searching myself, and I can find numerous pieces of research on both sides of the fence, including the Bath University piece I referenced earlier. But any empirical evidence that does exist can only be with respect to moderately negative rates as employed by the European Central Bank or Bank of Japan, since the sort of substantial negative rates Rogoff is championing haven't been implemented anywhere. Indeed, much of the positive opinion on negative rates seems to come from research by, and on behalf of, the central banks that have undertaken negative rates themselves (for example, this piece by the ECB). Are these impartial peer-reviewed studies? The ECB's recent use of other policy measures seems to say almost as much about what they think about negative rates as these published endorsements.

"Imagine that, rather than shoring up markets solely via guarantees, the Fed could push most short-term interest rates across the economy to near or below zero"

Again, I think this may miss the point. The issue that is facing the firms, cities and states that Rogoff believes will be helped by negative interest rates during this Covid-19 crisis is not debt-service costs, but basic cash-flow. What I believe is needed, and what seems to be happening in most economies around the world, is large-scale lending to alleviate the fact that corporate earnings have all but dried up, backed up by huge dollops of fiscal stimulus to support demand. The guarantees that the article decries, provide the protection for lenders to extend this necessary lending without having to worry about future capital losses. Reducing the price of money to negative might help a bit, but only at the margin, because this really isn't the problem, as it doesn't guarantee the lenders that they get their money back. Negative rates also have significant negative consequences for some parts of the economy – creditors and savers, for example.

5 A number of important steps are required to make deep negative rates feasible and effective. The most important, which no central bank... has yet taken, is to preclude large-scale hoarding of cash by financial firms, pension funds, and insurance companies

I would very much like to see the justification for this claim. This doesn't chime with our experience at all. So far, the evidence from credit markets is that financial institutions like pension funds have been piling into this stuff. Recent data from BofA indicates that cash holdings of financial institutions are now only marginally above historical norms, though they have been higher.

6 "Negative interest rates have elicited a blizzard of objections. Most, however, are either fuzzy-headed or easily addressed"

There is a good reason for the blizzard of objections, and that is the growing evidence of a so-called "reversal rate", at which the negative impacts of low interest-rates outweigh the positives. This need not even require rates to turn negative but could happen at low positive rates. I don't believe it is helpful to describe anyone who does not share your views in this complicated field as "fuzzy-headed", and I don't believe that citing his own 2016 book for support adds any weight to his argument. I'd add a similar disclaimer to any statement which starts "*it is not rocket science*", which precedes some other comments. Had it been rocket science, it would all be very much simpler and less open to debate. Rocket science, unlike economics and financial markets, operates according to robust and predictable Newtonian physics.

Textbook oversimplification

The underlying assumption underpinning much of Rogoff's argument seems to be the textbook assumptions that substitution effects of rate policy changes always and everywhere dominate the consumption (investment) / savings decision. Most textbooks represent this relationship as a downward-sloping straight line. But that is only a stylistic representation, and most of these books were written long before negative interest rates, or even very low nominal positive rates were even considered a possibility.

The more likely reality, in my view, is a non-linear relationship. An interest rate (which is the price of money) is basically the cost of having consumption (or investment) now instead of waiting to have it later. Alternatively put, it is the reward for waiting to have more consumption later (and so more consumption in aggregate). Higher rates reward saving with more consumption later, and more in total when simply aggregating the present with the future and not worrying about net present values.

But with all prices, if they fall far enough, another effect can come to dominate – and that is the income effect. As rates fall, there may be substitution of present consumption for future consumption, but if they fall far enough, falling expectations of future consumption may deter even present consumption. If this sounds familiar, then you may be in your 50s or 60s looking at how miserably performing your retirement savings pot is, and wondering how dismal an existence in retirement you will have on the predicted returns.

And all of this assumes that the financial industry would happily keep lending at negative rates even though sharply negative rates would undermine the entire maturity transformation model on which most bank lending is based.

Much of what I take issue with in this note is the veneer of certainty with which the author makes his claims without, it seems, all that much to support them. I think the article pays insufficient heed to the practical difficulties of the unintended negative consequences of negative rates on the financial system and relies on (very mixed) empirical support for something quite different to what he is proposing.

This is only my personal view. But why not read his article and decide for yourself.

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Listen: Will Climate Action Survive Covid-19?

It was supposed to be the defining year of Climate Action. But the outbreak of Covid-19 and economic destruction left in its wake have created an even more pressing emergency, and some fear that climate action could become another casualty of the crisis. In this podcast, ING's Mark Cliffe explains what the pandemic could mean for the future of our planet

In this podcast, Mark Cliffe, Global Head of ING's New Horizons Hub, tells Senior Editor Rebecca Byrne why a sustainable recovery needs to be more than just 'green', why people must come first and why the US Presidential election in November will be so consequential.

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Article | 16 June 2020 New Horizons Hub

Central Bank Digital Currencies: Challenges for commercial banks

The Covid-19 pandemic is speeding up central banks' studies on creating their own digital currencies. Big questions remain, however, about how they'll evolve and how they'll work in practice but the consequences could be revolutionary

Renewed interest in digital currencies

Digital currencies are rapidly moving up the agenda for commercial banks. Although Facebook has been forced back to the drawing board with its grand Libra global currency plan, the Covid-19 pandemic is giving dramatic impetus to the central banks' studies of creating their own digital currencies. Aside from the sudden jump in cashless contactless payments, the pandemic is sparking renewed interest in the potential for central bank digital currencies (CBDCs) to expand the monetary policy toolkit to tackle a dramatic recession. CBDCs could help get cash or even loans quickly out to people and businesses or allow interest rates to be driven into sharply negative territory. But the implications for the role and profitability of the commercial banks could be profound.

Until recently the commercial banks were working on the assumption that central banks would concentrate on Wholesale CBDCs rather than Retail CBDCs. This would not be disruptive. Indeed, it would largely be welcome for the commercial banks. Wholesale CBDC would only be available to selected financial institutions and would improve cross-border settlements issues by speeding up transactions while reducing costs and scope for errors.

The consequences could be revolutionary

But now commercial banks are having to tune in to the prospect of Retail CBDCs being launched. The consequences could be revolutionary. Banks could find themselves competing with the central banks as well as the Big Tech companies. Indeed, some of their activities might even be taken over by the central banks. Universal access to the central bank balance sheet, and the creation of a new-risk free asset, would create new opportunities but also raise new challenges for central banks, commercial banks and financial markets.

What form CBDCs take will undoubtedly be complicated by the fact that different central banks will pursue different motives, strategies and experiments. Aside from improving existing payments infrastructures, some will also be looking to promote financial inclusion or curb financial crime and the black economy.

Big questions revolve around how the private and the public sector will divide up their roles and responsibilities. One key choice would be over whether the Retail CBDC would be exchanged using account-based ledgers or digital tokens. Another would be whether it is distributed directly by the central bank or via banks or other intermediaries. In its purest form, an account-based directly issued CBDC would be particularly challenging for commercial banks. They would find themselves competing for deposits with the central bank, which would be especially hard if the CBDC offered attractive interest rates or if a crisis triggered bank runs. It also begs the question of whether and how the central bank would make loans.

A token-based CBDC might be the least disruptive scenario

Given that central banks, at least for now, lack the resources for such a radical takeover of banking functions, it perhaps more likely that CBDC will be distributed through banks and other institutions. This would allow the central banks to avoid much of the cost and risk of screening and servicing customers, providing complementary services (such as cards and investment products), and building and running the technology and operations.

In principle, a token-based CBDC might be the least disruptive scenario since the tokens would effectively be digital versions of cash and avoid the burden of account management and verification. However, if this were to allow non-financial players like the Big Tech companies (such as Facebook with Libra) into digital finance this would increase competition in an already highly contested market, further reducing margins and challenging the banks' customer relationships.

The emergence of CBDCs, therefore, raises some deep strategic questions for the future of the commercial banks, at a time when their profitability is already challenged. They should welcome the timely arrival of the Digital Monetary Institute to address them.

***ING, through its New Horizons Hub, is a founder member of OMFIF's Digital Monetary Institute. An edited version of this article appears in its latest journal** here.*

Further references and links: Central bank digital currency

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Retail investors and the 'discovery' of USD speculation

Data from trading platform Robinhood shows that bets on a USD bullish ETF spiked in March. While retail investors may have contributed to the rise in equity volatility, their very marginal role in the FX market suggests this was not the case for the USD. However, retail data may still provide some additional information on positioning

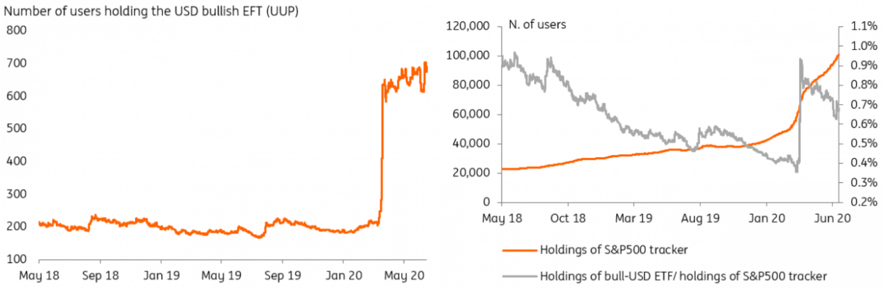
The fierce recovery in global equities after the pandemic-induced crash in March encouraged a deeper scrutiny of various actors in the market. One of these, retail investors, has lately been in the spotlight, prompting many to analyse users' stock holdings data provided by online trading platforms for non-professional traders.

We attempt a similar exercise with FX, focusing on the dollar. Using flow data from the online trading platform Robinhood (through the database "Robintrack") we analysed the dynamics in the speculative buying of the USD in the past months.

Retail investors jumped on the bull-USD wagon…

The most popular way of entering a long speculative position on the dollar through Robinhood is the PowerShares DB US Dollar Index Bullish ETF (UUP index) which tracks the performance of the USD versus a basket of six currencies (EUR, JPY, GBP, CAD, SEK, CHF). Figure 1 shows the number of users holding the UUP index in their Robinhood portfolio over the past two years.

Figure 1 & 2



Source: Robintrack.net, ING

It can be quickly noted that bullish bets on the dollar rose sharply around mid-March, coincident with the jump in USD spot. If it's true that retail investors rode the recovery in equities, this shows they also followed the big dollar appreciation.

Interestingly, the number of holders did not decrease as the dollar pared most of its gains in the subsequent weeks till June (15 June is the latest reported data). This, however, may simply be the result of more users subscribing to the platform and starting to invest, compensating for those who left their bullish positions. While we could not retrieve daily subscribers' figures, the holdings on the S&P500 ETF (SPY) provides an idea of the constant flow of new investors in the past few months, which appears untouched by the actual swings in the equity market (Figure 2, orange line).

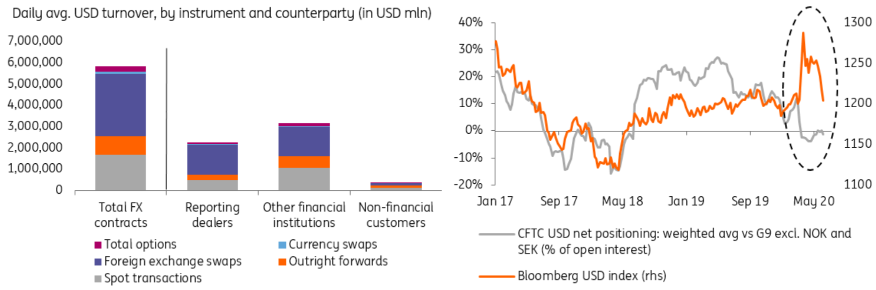
Dividing the holdings of the USD tracker by those of the S&P500 tracker we can see the actual bullish interest on the USD starting to abate after peaking in March (Figure 2, grey line).

…but their role in the FX market remains marginal

There are some obvious limitations to the informative power of these figures. If nothing else, the number of USD bullish investors in Robinhood is rather small – around 700 after the March spike – both in absolute terms and compared to the S&P500 tracker. Our goal here, however, is only to take this as a proxy of what has likely happened in a number of USD-bullish funds across various trading platforms.

Another drawback is the lack of detail on the amount invested by each user and therefore the total flow to the fund from the platform. Regardless of the actual volumes, it appears unlikely that retail investors played a role in adding volatility to the dollar in past weeks. BIS turnover data gives an idea of how non-financial customers already account for a tiny portion of daily USD transactions (Figure 3). Retail investors would then represent a fraction of these non-financial customers.

Fig. 3 & 4



Source: BIS, CFTC, Bloomberg, ING

What is this data telling us?

What we can conclude after looking at the data is that:

- When a new group of retail investors discovered equity trading in March, they also discovered FX as a speculative opportunity.
- They appeared to have hung on to their long positions after March, although their interest compared to the rising bets on the S&P500 (which can also be seen as a proxy for the number of total users) has started to wane.
- It is unlikely that retail investors have generated or materially contributed to the rise in USD volatility.

One possible alternative application for these figures is from a positioning point of view. As we have repeatedly stressed in our regular commentaries on FX positioning (here's the latest one), CFTC positioning data has failed to absorb the recent swings in the FX market. The case of the dollar is emblematic: as shown in Figure 4 above, USD aggregate positioning (which is a weighted average vs G9 excluding NOK and SEK, which are not reported by the CFTC) showed relatively contained and uncorrelated moves compared to actual USD moves.

We are clearly not suggesting to use retail investor data as an alternative to traditional measures of market positioning, but the unreliability of such traditional measures recently may raise the informative value of some unconventional indicators.

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