

In case you missed it: Meetings and deadlines

The US is growing, and at a much better pace than many expected but across the pond things aren't looking so great. The ECB meets next week and hopefully, we'll get a glimpse of what is cooking behind closed doors. Will the tide finally turn in favour of PM May's Brexit deal or will we get a short delay? But first, China's 'two-sessions' kicks off on the weekend

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US: Proving the doubters wrong

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Source: iStockphoto

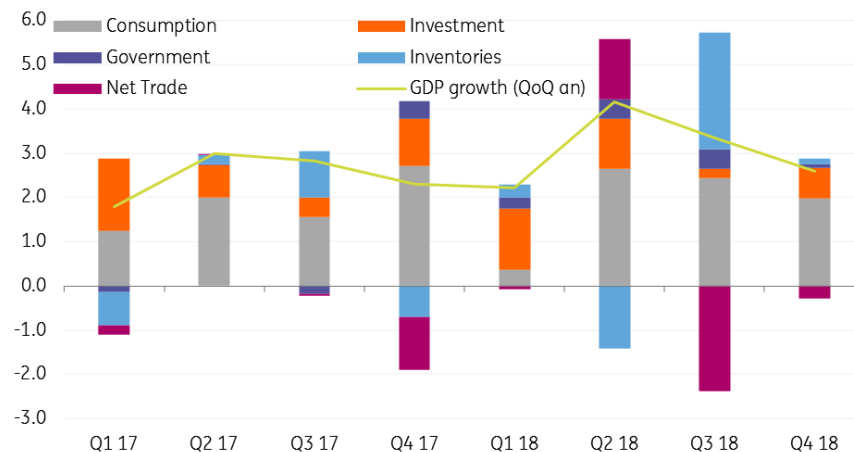
Battling against the headwinds

4Q18 US GDP growth has come in above expectations at 2.6% annualised – better than the 2.2% consensus and the 1.9% figure indicated by the Atlanta Federal Reserve NOWCAST model based on officially reported data. The details show a partial slowdown in consumer spending growth (2.8% versus 3.5% in 3Q18), but it continues to make a strong contribution. In fact, given the equity market turmoil at the time and the poor official retail sales figure for December, this isn't a bad outcome at all.

Non-residential investment spending actually posted a decent performance, recording growth of 6.2% despite the concerns about what escalating trade tensions could mean in terms of supply chains and corporate profitability. However, net trade was a drag (-0.22 percentage points) in part for the same reason, as businesses looked to import supplies ahead of anticipated tariff hikes in January. Those additional tariffs were pulled in December as the US announced a temporary truce with China on trade, which has subsequently been extended by President Trump.

Rounding out the numbers, residential investment was poor at -3.5% - the fourth consecutive quarterly contraction – while government spending grew by just 0.4% and inventories added just 0.13 percentage points to headline growth.

US GDP growth and contributing components



Source: Macrobond, ING

Favourable fundamentals

In terms of the outlook for the first quarter, things look to be in decent shape despite the disruption from the government shutdown. Employment growth is strong and wages are accelerating, which should support consumer spending. Equity markets have rebounded sharply, recovering the October-December losses, while gasoline prices remain subdued, helping to boost household real disposable incomes. The trade truce is also a positive development, but obviously a concrete deal in the coming months that would lead to a clear de-escalation of US-China tensions would be ideal. Imports may reverse after the surge in 2H18, but inventories are also likely to be run down for the same reason.

At this early stage we suspect something in the 2-2.5% range for 1Q GDP growth looks possible. With a strong jobs market creating more significant wage pressures we continue to believe the next move in the Fed funds rate is more likely to be up rather than down as the market is currently pricing (summer 2021 25bp rate cut currently priced by futures contracts). While the Federal Reserve will be patient, we think the combination of decent growth, low unemployment and gradually rising inflation pressures will lead to a re-evaluation over the summer with a rate hike likely in 3Q.

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What next for Brexit with 30 days to go

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Source: Shutterstock

? What happens next

The big news this week is that Prime Minister Theresa May has ceded to pressure from a cross-party group of lawmakers and has laid the groundwork for a possible Brexit delay.

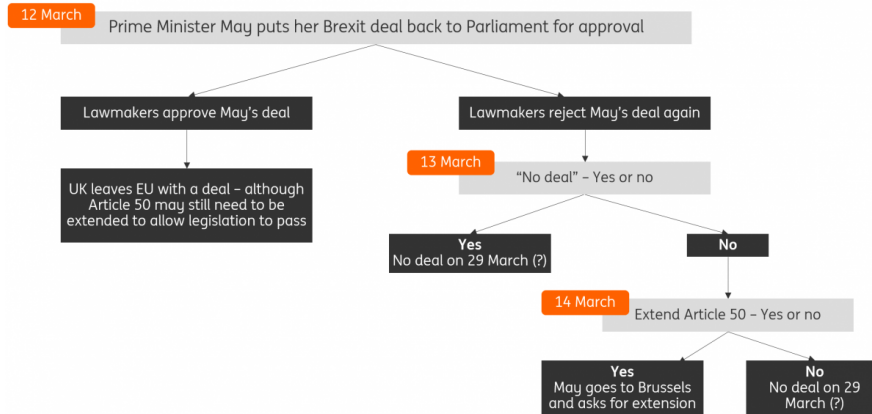
The PM has promised MPs a final meaningful vote on her Brexit deal by (or more likely on) 12 March. If the deal fails to gain approval, then she will return the House of Commons the next day to ask lawmakers whether they would like a 'no deal' Brexit. While MPs rejected an SNP-led push to symbolically rule out a 'no deal' Brexit on Wednesday evening, it still seems very unlikely that lawmakers would actively vote for this outcome.

Assuming then that the answer is a resounding "no" to 'no deal', the Prime Minister will return on 14 March to give lawmakers a vote on extending the Article 50 period. Judging by the latest round of Brexit votes on Wednesday, it's likely that MPs would back a delay – although of course, as this vote is still two weeks away, we won't know for sure until much closer to the 29 March deadline. There's also still plenty of uncertainty surrounding how long a delay would last, although it seems that the wind is currently blowing slightly towards a shorter extension (at least on the UK-side of the equation).

With all of this in mind, there are two questions worth asking: 1) Does the threat of a Brexit delay make it more likely MPs will back May's deal after all? and 2) With the next set of

Brexit votes still two weeks away, what does this all mean for the economy?

The road to a possible Brexit delay



Source: ING

Despite the threat of a delay, May still faces an uphill battle to get her deal approved by Parliament

Now that the road to an Article 50 extension had been partially laid, there's a lot of debate over whether it is now more likely that the Prime Minister's Brexit deal will be approved after all. For many Brexiteers, the idea of a delay to the 29 March deadline is very unpalatable, and the looming vote on extending Article 50 could prompt some MPs to start re-considering May's deal.

Renewed chatter about a second referendum over coming days may also weigh in on the decision facing the Brexiteers. Following Parliament's rejection of Labour's preferred customs union strategy on Wednesday evening, all eyes are on the main opposition party to see whether they will endorse a second public vote, as had been hinted earlier this week. Admittedly there still appears to be some reluctance from Labour Leader Jeremy Corbyn to go down this route, and officially the party are still keeping a range of options on the table.

Either way, the pressure appears to be building and there have been signs that some members of the hardline European Research Group (a caucus of pro-Brexit Conservative MPs) may be looking for a ladder to climb down. Jacob Rees-Mogg, head of the ERG, suggested to the Financial Times that he'd be "quite happy with an appendix" which put forward some legal fixes to his concerns on the Irish backstop. Previously he, like the Democratic Unionist Party (DUP), had said the backstop would need to go entirely if he was to be won over.

However, there a couple of reasons why it's probably too early to think the tide will suddenly turn in favour of May's deal before 12 March.

It's still too early to assume the tide will suddenly turn in favour of May's deal

Firstly, there's no guarantee that the EU will accept the legal changes the ERG and others are pushing for. In fact, the gap between the EU's position and the ERG's demands still seems fairly large - Brussels has said many times now that a hard end-date on the Irish backstop, or a unilateral exit mechanism, are both non-starters. That's partly because the EU cannot be fully sure these changes would be enough to persuade Parliament to suddenly swing behind the deal.

Secondly - and this is perhaps the key point - Theresa May appears to be leaning towards a pretty short delay, maybe only as long as two-to-three months. The Brexiteers will be acutely aware that not much is likely to change during this time, meaning 'no deal' remains on the table, and implying they may be tempted to sit tight for now and vote against May's deal again on 12 March.

The situation could begin to look slightly different though if the idea of a much longer extension (say 9-12 months) starts gaining traction. Many things could happen in that time, including perhaps a reversal of Brexit altogether. For the pro-Brexit MPs, this means that - in theory - there's a chance the meaningful vote on 12 March might be their last opportunity to enact Brexit at all.

As things stand though, our feeling is that the Prime Minister will still find it extremely tough to get her deal passed by lawmakers in two weeks' time.

The economy will struggle until we know for sure Article 50 has been extended

While it looks increasingly likely that Brexit will end up being delayed, the important thing for businesses is that we may not know for sure until there is little more than one week to go until 29 March.

While it looks likely MPs would back an extension to Article 50 on 14 March, it can't be 100% guaranteed - and even then, it will still presumably take a few days for PM May to return to Brussels and gain the unanimous EU approval that is required.

In the meantime, firms are likely to accelerate their 'no deal' contingency planning. A recent Bank of England survey conducted in December/January suggested a number of companies are yet to implement (or in some cases, create) plans for a hard Brexit. On the specific issue of goods trade, the [Department for Exiting the EU](#) noted this week that of the roughly 240,000 companies that are estimated to have only ever traded with the EU, only around 16% have applied for the registration number they need to be able to complete customs declarations.

British firms still preparing for 'no deal'

Percentage of firms that...



Source: Bank of England Agents Survey



If no deal, firms will need a registration number (EORI) to file EU customs documents

240,000

UK firms who have only ever traded with EU

16%

Of these firms have applied for an EORI number

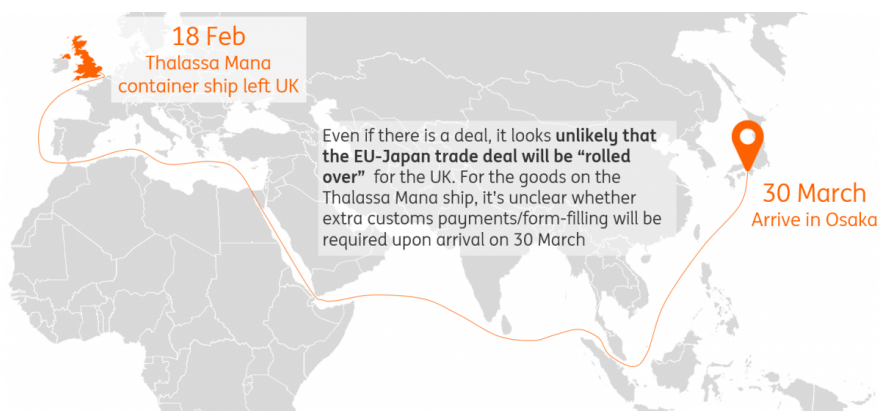
Source: DexEU

Source: Bank of England Agent's Survey, Department for Exiting the EU

These preparations come at a cost, and in the short-term, this planning process will continue to weigh on investment more broadly. Equally, as we inch closer to the deadline, the real-world impact 'no deal' will be increasingly felt too. To take one example, a week or so ago the Thalassa Mana container ship set sail from the UK to Japan. Given that the EU-Japan trade deal looks unlikely to be 'rolled over' for the UK in time for 29 March, the firms who have sent the goods on this ship and others like it, have no idea whether their products will be subject to additional customs or administrative costs upon arrival.

The upshot is that economic growth will continue to struggle over the next few weeks. What happens then largely depends on how long an extension to Article 50 lasts - [we discussed this in more detail in a separate infographic](#)

Meet the Thalassa Mana, the ship sailing into the unknown...



Source: CNBC, MarineTraffic

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China: What to expect from the Two Sessions

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Source: Shutterstock

Work report to follow the Central Economic Work Conference

The Two Sessions, or back-to-back meetings of China's major political bodies, will take place on 3 March (Chinese People's Political Consultative Conference) and 5 March (National People's Congress).

It's a bit strange this year that official media has not put out a dedicated page for these meetings but we believe this could be because [the Central Economic Work Conference](#) has already drafted the direction of economic growth, fiscal stimulus and monetary easing for 2019.

Still, we're looking forward to reading the government work report on 5 March because it's expected to announce a set of economic targets for 2019.

What to expect in the government work report

GDP target

We expect that the GDP target will not be lower than 6%, to reinforce the Central Economic Work Conference's main priority of providing job stability.

It's possible that the work report will announce a target range for GDP growth, or just repeat last year's growth rate of around 6.5%. Our forecast for this year is 6.3%.

If the GDP target range were to be set between 6% and 6.5%, investors would almost certainly fixate on the lower end of the range at 6%, which could create hiccups in the market. But we expect this would be a temporary setback, as investors have been aware that growth could take a hit due to growing trade tensions and, in theory, should have been preparing for a lower target.

A more worrying sign would be if the government announced a future five-year average of around 6%. This could really create market concern of a deeper slowdown.

2 Fiscal budget

We expect the fiscal deficit will be 3.0% of GDP. But China's actual fiscal deficit is usually 0.5 percentage points higher than the planned deficit. We expect it will be even greater than that because this year is intended to support economic growth. We forecast the fiscal deficit at 4% of GDP.

We will be focusing on whether the government is prepared to invest in infrastructure to support the economy. From this, we will be able to gauge the severity of the headwind from the ongoing trade dispute.

Aside from infrastructure projects, the work report could also focus on tax cuts. We don't believe tax relief would be as effective at stimulating the economy during a downward cycle as infrastructure spending, but some changes in this area would be an important signal about how the government gauges the economic situation in 2019.

3 Monetary easing

Here, our focus will be the description of the yuan's path. Last year, the government committed to "keeping the yuan exchange rate stable at a reasonable equilibrium level". The US wants China to keep the yuan stable as part of any trade agreement, so the wording on this in the government's work report could form part of a final trade agreement.

We would not be surprised if the government drops its description of monetary policy as "prudent" so as to remain consistent with the recently-published monetary policy report. The emphasis will be to divert liquidity to small private firms, which suggests that the Targeted Medium Lending Facility could replace the Medium Lending Facility.

4 Economic reforms

We expect that economic reforms will focus more on improving public services such as providing affordable medicine to public hospitals, education and rural infrastructure to improve the quality of life.

Technology will also be in focus but we assume this will be a relatively low key item in the report to

avoid attracting further negative comments from the rest of the world.

Our view is that reform efforts will no longer include deleveraging or cuts to overcapacity this year. Economic conditions don't allow for further deleveraging, which would put additional pressure on growth.

The main focus will be....

In sum, we believe that the work report will be in line with the government's existing policy direction. If there is any divergence from current policy, it will likely be to provide more support for the economy.

For us, the main focus will be on the wording of the yuan's trend, as this could affect how trade talks progress.

ING China economic forecast for 2019

China	2017	2018	2019F
Real GDP (% YoY)	6.9	6.6	6.3
CPI (% YoY)	1.6	2.2	2.5
PBOC 7D reverse repo rate (% <u>eop</u>)	2.50	2.55	2.55
10Y govt. bond yield (% <u>eop</u>)	3.90	3.30	3.10
CNY per USD (<u>eop</u>)	6.51	6.88	6.75
CNY per EUR (<u>eop</u>)	7.80	7.87	7.76

Sources: ING, Bloomberg

Article | 28 February 2019

ECB preview: Trying not to get lost in transition

Confidence indicators are still falling but there is some bottoming out in sight. With that in mind, the ECB will have to balance between pre-emptive...



Source: Andrej Klizan

When the European Central Bank meets for its March policy meeting, the jury on the actual state of the eurozone economy is still out. Since the January meeting, most confidence indicators have continued their downward trend, which started last summer, but recently some tentative signs of a stabilisation have emerged. Whether these are credible green shoots of a bottoming out to be followed by a rebound in the economy, or simply a pause in the continuing deterioration, is simply too early to tell.

The latest ECB staff projection are very likely to show a downward revision of 2019 GDP growth (1.7% in the December projections). However, any revision which does not go lower than the current consensus of 1.4% is simply proof of the ECB's sense of reality and no reason to panic. Any significant downward revisions to the ECB's 2020 and 2021 GDP growth forecasts (1.7% and 1.5% in December) would be a much more alarming signal, particularly as this time around any changes to the forecasts would be mainly driven by changes in the fundamental assessment of the economy and not by revisions to the technical assumptions. Compared with the December projections, there should be no new impulse from oil prices. The effective exchange rate and bond

yields are somewhat lower but not low enough to push growth and inflation forecasts higher. This, in our view, also means that there will be hardly any changes to the ECB's staff projections for inflation (1.6%, 1.7% and 1.8% for the period 2019-2021 in the December projections).

Even though the latest round of ECB staff projections was supposed to provide more clarity and guidance, chances are high that the ECB will not be able to judge whether the current downswing is transitory or more structural. In fact, the only thing that is for sure right now is that the transitory period is lasting longer than the ECB had anticipated. For the rest, the eurozone still wobbles between decent domestic demand and increased external risks, and it remains unclear, in which direction the pendulum will eventually swing.

The bigger picture of possible next ECB steps

In this situation of increased uncertainties, a normal ECB reaction would be to sound dovish, stay on high-alert and tackle the situation with words not action. However, recent comments by several ECB officials have given rise to speculation about changes in the forward guidance on interest rates and the announcement of new Targeted Longer-Term Refinancing Operations (TLTRO). In our view, the discussion on these issues is ongoing but will not be concluded today. In more broader terms, what are these issues all about?

- The “funding for lending” scheme, TLTRO-2, has provided some €700 billion into the banking system. The first tranche of this TLTRO-2 will expire in June 2020 but due to regulatory requirements, a liquidity bottleneck will occur in June this year. In order to avoid any market disruptions, there is a need to present an exit plan for banks. This does not necessarily have to be another TLTRO at negative interest rates but a way should at least be found to allow banks to roll over their net exposures.
- When discussing new TLTROs, the important question is what the goal of another TLTRO should be. Is it to help banks? Is it to lower lending costs? Is there a supply or demand issue for lending? The ECB often refers to a functioning of the transmission mechanism of monetary policy, meaning that interest rates across the eurozone should be the same and not distorted by regional (banking) problems. However, there is no guarantee that new TLTROs would lower bank lending rates. Maybe they simply increase margins.
- More generally speaking, the ECB will eventually have to find tools in order to avoid an unwarranted tightening of monetary policy. As regards liquidity and bank lending rates, there are also other possible options like a deposit rate hike, LTROs at flexible rates, higher volumes on the interest rate free current account facility, new facilities for banks to park excess liquidity or a combination of two or more of these options. The big challenge for the ECB will be to balance the pros and cons of different options. For example, while another TLTRO would bring more relief to Spanish and Italian banks, a deposit rate hike would probably be welcomed by banks in core eurozone countries.
- In theory, forward guidance on rates is an easier instrument to adjust. With increased economic uncertainty, changing forward guidance to “interest rates to remain at their current levels at least until the end of the year” would be a no-brainer. However, this won't necessarily happen at today's meeting but rather at some point in the future. Also, a change in forward guidance could be used to sell a deposit rate hike as a pure technical correction by postponing a first policy rate hike for beyond the timing of a deposit rate hike. Finally, more clarity on the length of the reinvestments, i.e. an extension, could also be applied as a dovish instrument but more so in a situation of unwarranted increases at the long end of the yield curve.

Main goal: avoiding unwarranted tightening

The discussion at the ECB has only just started. The economic situation and the inflation outlook are still too uncertain to decide on either new stimulus, an extension of the current stance just to avoid unwarranted tightening or even some further normalisation. Consequently, the ECB will keep most of its cards close to its chest. However, at the current juncture, a traditional wait-and-see stance runs the risk of unintentional tightening of monetary conditions. Therefore, the ECB will have to carefully balance between too hasty action, which could be perceived as panic, and too much complacency. Everything the ECB does in the coming weeks and months will be aimed at avoiding unwarranted tightening, rather than shifting towards new easing of monetary policy.

As a result, we expect the ECB to announce that the Governing Council asked the relevant committees to look into options on how to deal with liquidity bottlenecks and bank profitability. The April meeting will then be the meeting where the real ECB action is. This, however, does not mean that today's meeting will be dull. Just getting a glimpse of an interesting and probably controversial discussion behind closed doors can be thrilling.

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Fed pause, lower FX volatility and the carry trade

FX volatility is sinking to the lowest levels seen since last spring. This is generating higher risk-adjusted returns and favouring FX carry trade...



Source: Federal Reserve

Fed pauses, FX volatility sinks

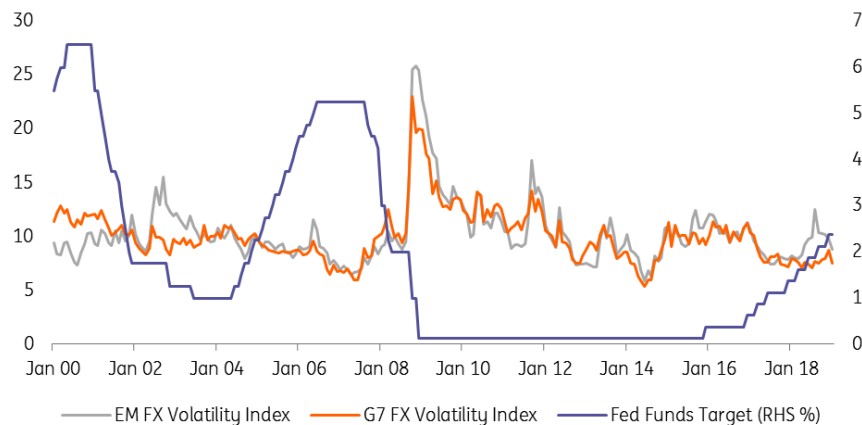
Fed Chair Jay Powell today starts two days of Congressional testimony on monetary policy. His remarks are expected to shed further light on why the Fed shifted to a data-dependent approach in January and cement views of a Fed pause.

At the same time, his remarks should echo the dialogue in the most recent FOMC minutes which suggested the Fed would stop quantitative tightening (shrinking its balance sheet) later this year. Recall the Fed had received some criticism (including from President Trump) that the US\$50 billion monthly reductions in its balance sheet was unduly tightening financial conditions and weighing on risk assets.

ING's house view believes the current Fed pause could resolve itself in one last rate hike – perhaps in 3Q19. However, the bar to that hike looks quite high and the Fed pause could easily turn into something longer – such as the twelve month pause in Fed rates seen between summer 2006 and summer 2007. The Fed Fund futures strip certainly prices that story, with the next full 25 basis point Fed move (a cut) not priced until summer 2021.

If the Fed is to be embarking on a long pause, the evidence of 2006 suggests that FX traded volatility levels can fall further – at least until there are clearer signs of a broader slowdown in activity, including the US.

Will FX volatility decline further on a Fed pause?



Source: Bloomberg

Lower volatility supports carry trades

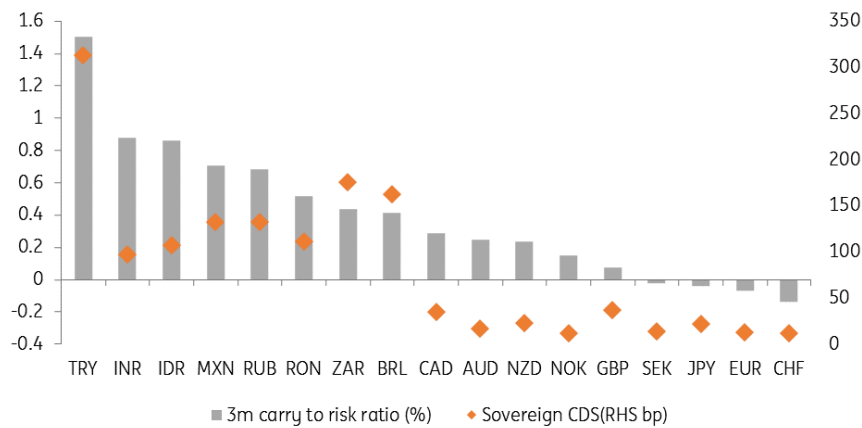
The decline in traded levels of FX volatility are supporting carry trade strategies. These typically perform well during benign periods of growth and when lower levels of volatility are increasing risk adjusted returns. Here, lower traded volatility is a gauge of expected volatility. And the lower the level of expected volatility, the more confidence an investor has in holding higher yielding FX.

One measure of the risk-adjusted carry is the carry-to-risk ratio, adjusting 3m implied yield (derived through deliverable and non-deliverable FX forwards) by implied FX volatility.

Currently, the Turkish lira stands out with highest volatility-adjusted carry, followed by the Indian rupee, Indonesian rupiah, Mexican peso, Russian rouble and Romanian leu. In the chart below, we overlay the carry-to-risk ratio with the sovereign CDS - a proxy measure for country risk.

Arguably the INR, IDR, MXN, RUB and RON could be in the sweet spot for higher carry and lower perceived country risk, although difficult elections (April/May), potential fresh US sanctions (late 2Q/early 3Q) and a possible downgrade (S&P ratings due 1 March) could dampen enthusiasm for the INR, RUB and RON, respectively. We have a preference for carry in the likes of MXN and IDR. (TRY is a higher risk proposition, although has its merits).

Carry-to-risk ratios versus sovereign CDS spreads

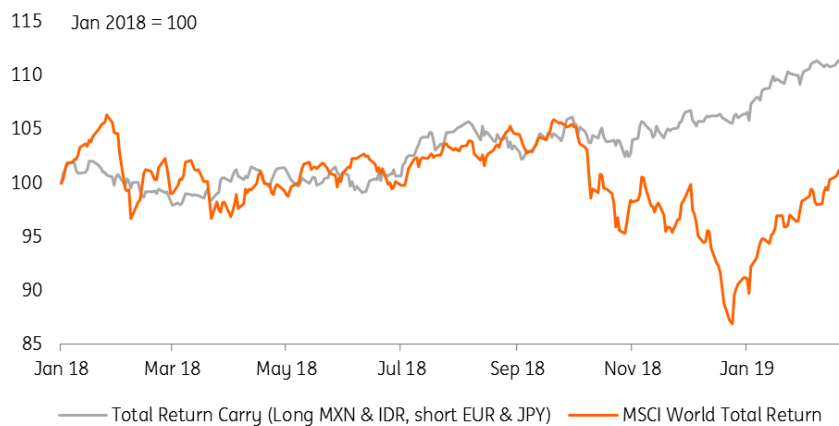


Source: Bloomberg

The right carry can out-perform equities

We certainly do favour FX carry trade strategies through the start of this Fed pause, although we would probably turn more cautious into late 2019 when the US is closer to a recession and US equities face more serious challenges. And while past performance is no guarantee of future returns, we do note that a carry basket of IDR and MXN, funded out of EUR and JPY, did manage to avoid the big drawdown seen in global equity markets towards the end of the last year.

The right carry can outperform equities



Source: Bloomberg

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Delaying Brexit: What does it mean for the economy and markets?

With time running out, it looks increasingly likely that the 29 March Brexit date will need to be pushed back. But there's a big question about how...



Source: iStock

Extending Article 50: What does it mean for the economy & markets?

As the clock counts down to 29 March, there is a growing sense that the deadline will need to be pushed back to allow more time to find a deal that the UK parliament can get behind. One way or another, it's looking increasingly likely that [lawmakers will get a two-way vote between 'no deal' and an extension to Article 50](#) in mid-March. But even if the UK does ultimately request a delay via an extension to the two-year Article 50 negotiating period, there's a big question over [how long it might last](#).

A **shorter extension** might have short-term political and practical advantages, but it would likely be more damaging for the economy and could easily write off a Bank of England rate hike until much later in the year or beyond.

A **longer extension**, while potentially more politically awkward for the UK government, could see growth recover a touch in the near-term as the imminent 'no deal' threat recedes.

[Click here for a printer-friendly PDF version of this graphic](#)

	Shorter extension e.g. 2-3 months	Longer extension e.g. 9-12 months (or longer)
Pros	<ul style="list-style-type: none"> + More politically acceptable in the UK + Suitable if deal agreed by March and some extra time needed to get legislation through parliament + Avoids headaches surrounding European elections 	<ul style="list-style-type: none"> + More realistic time to find solution + Big year for Brussels (finalising budget/filling top positions) so kicking the can further could make Brexit less of a distraction for the EU in short-term
Cons	<ul style="list-style-type: none"> - If a deal isn't found quickly, it could create problems if UK has no MEPs. An A50 extension beyond July could therefore open door to legal challenges - Are two to three months enough time to find a solution? 	<ul style="list-style-type: none"> - UK would need to stage European parliament elections, which could be politically awkward in Britain
UK economy	<p>Assuming a deal is not in place before an extension begins, a 2-3 month delay would keep the 'no deal' risk alive. While it's possible the Article 50 period could be extended again, firms will be aware that each time this happens, the risk of the EU saying 'no' will grow.</p> <p>For businesses, a series of small extensions would also mean they are theoretically never more than 3-4 months away from 'no deal', which will increasingly take it's toll on investment.</p> <p>For similar reasons, consumer confidence would likely stay under pressure (currently at a post-2013 low). Individuals are likely to remain wary when it comes to big-ticket purchases and may opt to maintain savings, despite a better fundamental backdrop for consumers.</p>	<p>A longer extension would provide more reprieve for businesses, which may unlock some hiring & capital spending (particularly with a short investment horizon).</p> <p>However, having come to the cliff edge once, it's possible firms will use the extra time to insulate themselves from another 'no deal' scenario. The reason for extending Article 50 will matter a lot – e.g. a second referendum would take time to arrange and prolong uncertainty, but a lot would depend on whether 'no deal' was an option on the ballot paper.</p> <p>Either way, with the imminent 'no deal' threat off the table (at least temporarily), consumer spending may modestly recover. After all, the fundamental backdrop is improving: the jobs market has been resilient, helping to lift wage growth, while inflation has eased off.</p>
Bank of England	<p>If a deal is agreed and the UK leaves the EU after only a short delay, then a rate hike could come back into play. Given the likely near-term hit to growth, August may be too early, but if wage growth continues to perform strongly, a November rate rise is possible.</p> <p>However if the deadlock continues and Article 50 is extended again (maybe more than once), we think the chances of a rate hike this year would fade – particularly given the BoE's recent downgrade to its 2019 growth projections.</p>	<p>A Brexit delay to the end of the year or beyond may tempt policymakers to hike rates over the summer. The BoE has signalled it would like to gradually tighten policy further, with the economy operating with little or no spare capacity.</p> <p>However, this relies on the economy regaining momentum through the second quarter. If it doesn't, then it's equally possible that a long extension to Article 50 could result in a prolonged pause at the Bank of England.</p>
Markets	<p>Trade-weighted GBP is just over 3% higher this year, suggesting that some of January's Brexit optimism is still in the price. While a short delay in Article 50 could generate a temporary 1-2% rally in GBP (e.g. EUR/GBP to 0.85, GBP/USD to 1.33), the return of 'no-deal' fears in a few months could see gains quickly evaporate.</p> <p>The UK money market curve has flattened some 10-12bp from the highs seen in mid to late January. 5-10bp could go back into the curve on a short delay. However, little clarity over whether the BoE would have a window to hike would limit the steepening.</p>	<p>GBP rallied to the best levels of the year in January, when the Cooper-Boles amendment held out the prospect of a long delay (and even a route to a second referendum). Confirmation of a 9-12 month delay, buying time for alternative policy paths, could trigger 4-5% GBP gains (EUR/GBP to 0.83, GBP/USD to 1.36).</p> <p>October was the last time the UK money market curve felt confident in pricing in a 25bp BoE hike over the coming 12-months. A long delay and the scope for a BoE hike this August could see the curve steepen 25-30bp out to the two-year horizon.</p>

Source: ING

[Click here for a printer-friendly PDF version of this graphic](#)

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New Money III: Why the crypto debate is far from over

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Source: Shutterstock

The debate around crypto is far from over

There is no doubt that 2018 was a reality check for crypto enthusiasts. Q4 2018 saw a strong contraction in the cryptocurrency market, which led to a 45% loss of almost \$100 billion in market capitalisation. This is hardly surprising: the value of peer-to-peer cryptocurrencies has no clear economic or legal basis. As we argued [elsewhere](#), they do not satisfy the three basic functions of money: store of value, means of exchange and unit of account. Therefore, the steep increase in the exchange rate in the early stage of their adoption was simply unsustainable. However, although the hype around Bitcoin is rapidly fading away, the debate around crypto remains quite active and far from over, so here are few reasons why you do need to keep watching this space.

The rules of the game: “in algorithm we trust”?

Crypto supporters often argue that with blockchain technology and cryptocurrencies it is possible

to build a financial eco-system with decentralised governance. Yet there are several issues with this idea. Firstly, before you can trust an algorithm you need to trust its coder. Ultimately, the “money” business is a “trust” business. Some people say: trust the code, instead of the intermediary. But most people cannot interpret the code. So people need to hire someone to vet the code for them. But wait, that's just an intermediary. Only this time, it's an auditor.

Secondly, we think that a centralised governance is more likely to succeed given the strong economies of scale behind the proliferation of digital assets. The economic forces driving digital assets are no different than a platform-dominance game: the value increases (for all customers) as more clients join. For example, having one phone in a network is useless, but having 10 phones is much more useful. By extension, the value of the network increases as more people join the phone network.

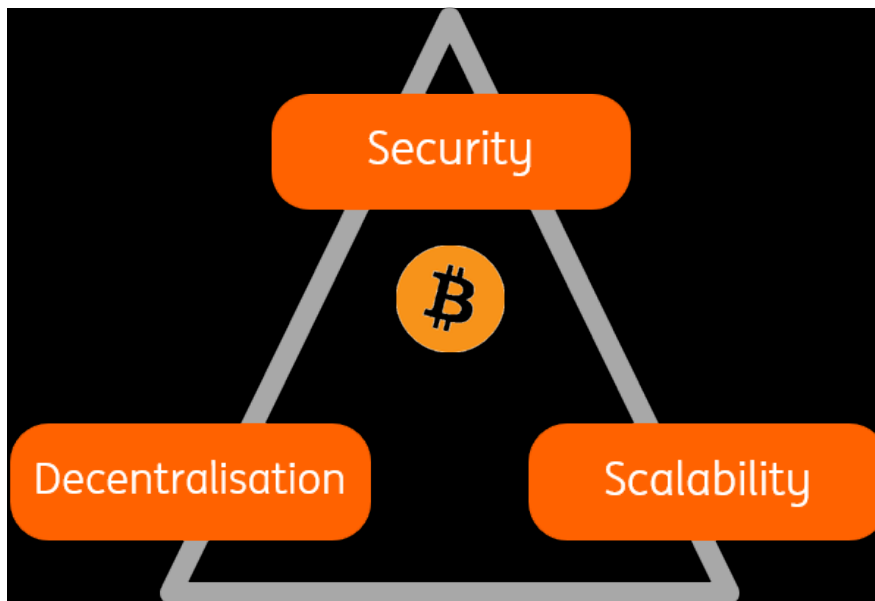
An area where algorithms could potentially assist is in the conduct of a monetary policy rule (e.g. Taylor rule). However, it is hard to imagine monetary policy on “autopilot” without some form of public accountability. What would happen when things go wrong and who would bear the ultimate responsibility? But more importantly, monetary policy is often discretionary rather than rules-driven. There is a difference between decentralised software, and a market without public intervention. Maybe technology could help to address the first issue, but market failures do exist irrespective of technology. Therefore, don't expect public intervention to disappear following a technological innovation – not even a breakthrough one.

Can cryptocurrencies escape the “impossible trilemma” curse?

So, what is stopping governments from adopting cryptocurrencies? There are two main issues, one relates to technology, the other one to international finance and politics.

The first issue is the *Scalability Trilemma*, which describes the impossibility, at least with current technology, to have scalable, secure and fully decentralised cryptocurrencies all at the same time (Fig.1). In other words, you can pick and choose two out of three options, never all of them together. Bitcoin, for example, prioritised security and decentralisation over scalability. Conversely, if you want a decentralised and scalable cryptocurrency, you have to make concessions on security. You can't have them all.

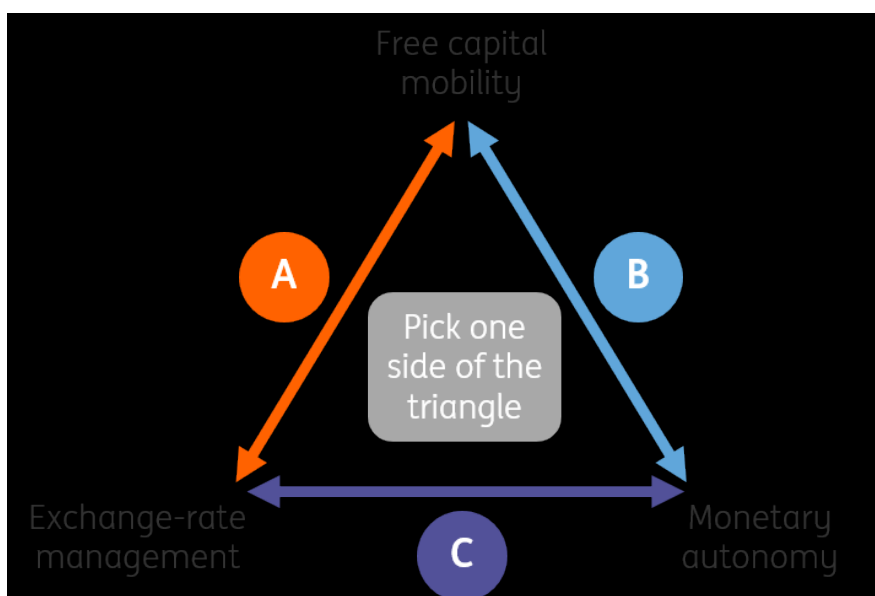
Fig. 1 - The Scalability Trilemma



Source: Vitalik Buterin, J.Dwyer

The second issue relates to another popular [Impossible Trinity](#), which states that a country cannot achieve free capital mobility, monetary policy autonomy and a stable exchange rate all at the same time (Fig. 2). As an example, if a small open economy decides to peg its exchange rate to that of a more developed country, then according to the trilemma, the smaller country is confronted with a choice: either it preserves the freedom to conduct monetary policy in the presence of capital controls, or alternatively it binds its monetary policy to that of the other central bank preserving free capital movements. If two countries had, for example, two different policy rates in the presence of free capital mobility, strong capital flows would add further pressure to break the parity.

Fig. 2 - The Policy Trilemma



Source: Source: Lars Oxelheim (1990). The chart is a reproduction appeared on The Economist.

So, how do cryptocurrencies fit within the latter? On the one hand, governments can shut down cryptocurrencies at any time. However, the main point here is that even if governments were to adopt a cryptocurrency as their legal tender, the Impossible Trinity would bind governments to stick to either option A or B in the chart above, effectively diminishing their “policy menu”.

These are two important reasons why we don’t expect a wide adoption of cryptocurrencies in the new future. In our view it is more likely to see progress on central bank-issued digital currency, which is the topic of a separate New Money article. Moreover, the blockchain technology underlying cryptocurrency remains promising. One area where we see a lot of potential is that of securities trading on a blockchain platform: security tokens, which we will also address in a separate New Money article.

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