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Patrick Minford argues that the right policies will ensure a total post-Covid recovery

The limits and pitfalls of QE in emerging markets are discussed by Daniel Dăianu

Benjamin Zeeb believes that Europe needs a Plan B to thrive post-pandemic

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The end of time

The COVID-19 pandemic and governmental response to the virus is compounding and exacerbating threats to the global economy, including higher public debt burdens, de-globalisation and an expanding role of the state. Governments have been quick to accept the assertive and articulate campaigning of various interest groups, covering everything from climate change to transgender rights, and it seems there is a disconnect between the average man on the street and the policy-making elites around the Western world.

The last forty years of economic reform has seen a huge growth in wealth, living standards, welfare and environmental protection. To slow down or reverse this greatest period in history there is a call for sustainable development, and that this will be the sure-fire guarantee to improve living standards. We are told that the only sustainable recovery will be a Green one. The Green recovery programme promised by the likes of the EU, or other multilateral agencies or multinational corporations, boils down to a transition to a low-carbon economy to save the world from what they assure us will be an impending climate catastrophe.

No matter that the likes of India and China, committed to improving the standards of living of their citizens by the only means available, will ensure that their people have access to cheap energy and electricity powered by fossil fuels.

What are low-carbon technologies? Curiously, they seen to exclude nuclear energy. And as the example of California has shown, the push for renewable energy seems to have ushered in an age of 'Third-Worldism' in America's most advanced state, where residents cannot be assured of electricity 24/7. Green energy advocates propose a huge increase in the use of wind, solar power, and electric cars as part the sustainable recovery post-COVID-19.

There is no room for debate. Some might say that there is no room for facts. There is an acceptable position on mankind's influence on the climate, just as there is an acceptable position on Trump, one acceptable position on Brexit, one acceptable position on slavery, and so on, and so forth.

This is a symbol of a deeply unhealthy society, and of a political and a cultural elite that is insecure when it comes to opposition. The COVID-19 impact can be seen as an inflection point on how the global economy will operate in future decades.

Will it be a continuation of the high growth of the last forty years, with the billions of people in Africa and India reaching first world standards of living? Or will it be a dystopian future of a process of de-industrialisation, a first in modern history?

Time will tell. ■

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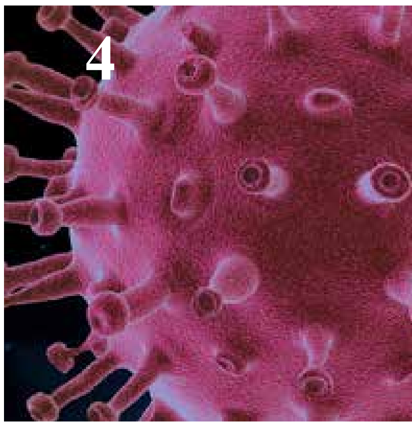

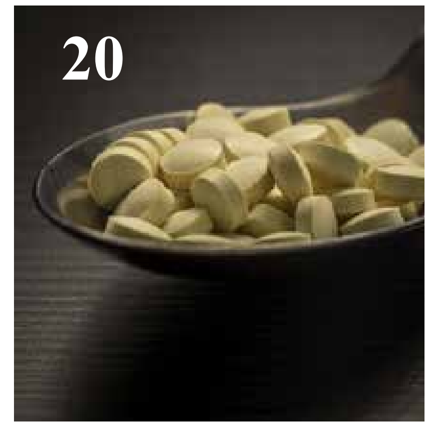

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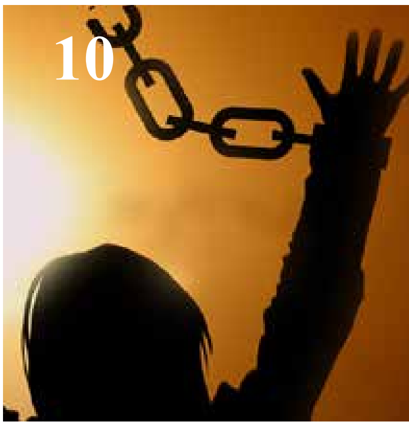

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The coronavirus crisis: prospects and policy

Patrick Minford is Professor of Applied Economics at Cardiff University

Forecasters protect themselves by being gloomy. This is because their clients want the future to be bright and will tend to act on bright forecasts. The forecasters who provide those will then be blamed if things go wrong, as the firm will have overspent assuming the best. A gloomy forecast, if things turn out better, will not be remembered in the firm's delight at events. This imparts a gloomy bias to forecasts.

The virus crisis is no exception. Yet it is an unusual crisis, in being mainly created by deliberate suppression of the economy by the government. In principle the lifting of the lockdown removes that suppression, so automatically regenerating activity.

This is quite unlike a typical recession brought on by say a commodity shortage price shock, or a consumer- or firm-led collapse in demand and confidence; in these cases the government has no control. It can try to offset these things; but its success is hard to predict.

On this occasion the government can remove the cause because it is the cause. It is true that in addition people are fearful of the situation and may therefore spend less, while firms may also conserve cash.

However, much of this fear is the result of government warnings about high chances of dying from the virus. As deaths come down and lockdown easing goes ahead, these warnings should be toned down and popular sentiment will become braver, as well as more impatient of restraint.

Pre-COVID-19, people behaved robustly towards risk; but the crisis has changed that behaviour towards great timidity. This looks unlikely to last as lockdown is eased around the world and deaths continue to fall. Just as people go back to driving normally after accidents, so with attitudes to health risk as this episode winds down and the extreme alarmist forecasts of deaths prove to be false.

Our early-May forecast for COVID-19 deaths in the UK is shown on the right. Already daily average deaths are close to zero, as forecast. In this respect it is following the standard logistic path of an epidemic, including the effects of government and personal reactions. Our causal model of the epidemic supports this pattern.

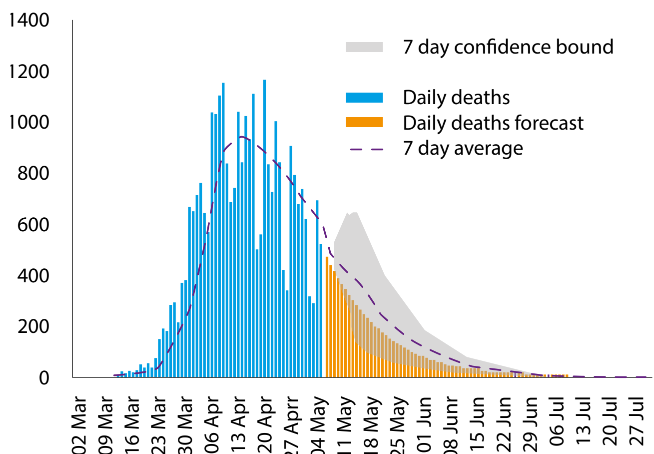
Some forecasters build in a second bad wave of infection, starting in the autumn. However, we think this is unlikely because the fatal strains of the virus have been essentially eliminated in the first wave by the deaths of those infected.

The other damaging non-fatal strains will have been killed off by antibodies in the surviving infected. The virus strains that survive will be those that caused less antibody creation and so created weaker symptoms. The death rate per infection of the common flu is around 0.1%; this flu virus coexists with us and we do not react to outbreaks by stopping our lives.

So it will be with new waves of COVID-virus outbreak, evolutionary biology suggests. The evidence so far from countries experiencing second waves supports this view. Out of about 28 such countries, around half have succeeded in avoiding a serious second wave by using localised track/trace/isolate policies. In all second waves the death rate per reported case has fallen sharply since the peak of the first wave.

Even if there is an outbreak worse than this assumes, we assume it will be responded to not by lockdown but by these effective localised responses. This is all without assuming a vaccine or a cure - both of which are possible if unlikely things to appear soon.

It is for these reasons that our forecast is close to a V-shape for the UK economy. Q2, where the lockdown was at its most severe, has predictably seen a large drop in GDP; even within



the quarter, June recovered by nearly 10%. Q3 will see a further rebound, and Q4 a yet further one.

By the end of the year the recovery will be total. What is in prospect for the UK is similar in other countries. The very latest indicators support this interpretation. Purchasing indices for the G7 suggest already GDP has recovered to year ago levels. This is influenced by China, where lockdown started and was lifted first. But other major economies are not far behind.

The fiscal and monetary policy response

A key element in recovery will be policy. Fiscal policy is in bail-out mode currently, issuing huge amounts of debt. Monetary policy is in massive QE expansion mode. Effectively the Bank of England is buying all the debt the government is issuing, creating a false market in gilts; the government is borrowing from itself not the market.

This QE needs to be wound down and gilts sold to the market at yields as close as possible to today's near-zero rates, to keep long term interest costs to the taxpayer as low as possible. Maturities of issued debt need to be lengthened for the same reason.

The time to do all this is in the rest of this year as recovery proceeds. The market in gilts should be able to absorb this debt; given the environment of insecurity that will prevail until the economy has fully recovered, private lenders will pay for safety.

By the end of the year this will change. Confidence will have returned and with it the huge quantity of money printed and lent out will start to fuel inflation. As we go into 2021, it will be necessary to tighten monetary conditions against this.

"By the end of the year the recovery will be total. What is in prospect for the UK is similar in other countries. The very latest indicators support this interpretation"

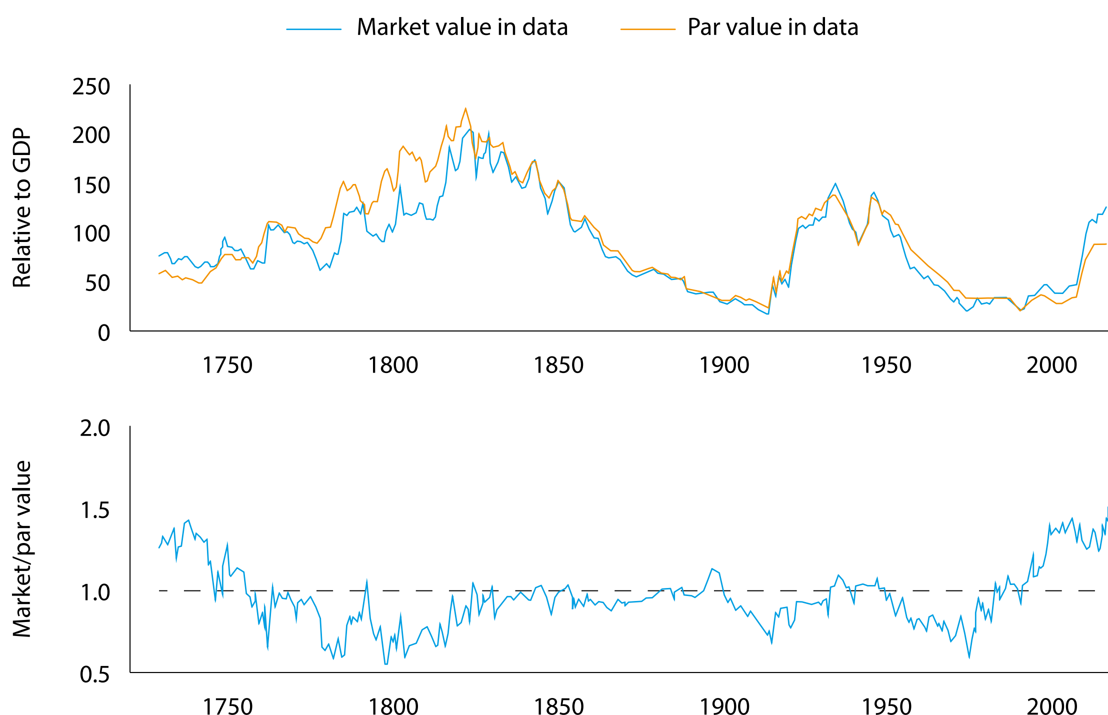
How fiscal policy copes with wars and other crises- and now the coronavirus

To get an understanding of how far the public finances can stretch to cope with national crises, it is helpful to look at UK debt history. The two charts above come from Martin Ellison and Andrew Scott's VoxEU article[1] chronicling UK debt history.

One can see that twice in UK history has the market value of debt/GDP spiked: once in 1830 after the Napoleonic wars, and once in 1945 after the Second World War. The first spike was to 200% of GDP, the second to about 150% of GDP.

The chart below it is also instructive. It shows the ratio of market/par value of debt. When this is high interest rates are low, a sign that the government is in a strong position to borrow, probably because the private sector is struggling. Notice how this ratio has surged in recent years, with the financial crisis.

Now look at how the bond market developed as Britain borrowed in the second half of the 18th century. The market/par ratio remained at or above unity, as the government built up debt. By the early 1800s the market/par ratio had fallen sharply. The private economy was resurgent and interest rates rose, devaluing the public debt.



One can see a rather similar pattern over WWII debt. As it was accumulated during the war, the market/par ratio remained a bit below unity. By 1950, the ratio had fallen sharply; interest rates had risen as the economy recovered, devaluing the debt.

How were these huge debt ratios paid off? After Napoleon, income tax was introduced. After WWII, inflation devalued debt while also taxes were raised.

Application to the coronavirus crisis

Apply this to the coronavirus situation. With lockdown threatening a recession lasting three months or more, the government support package has been put at £400 billion as a rough round number, about 20% of GDP.

If lockdown were to go on for longer, as we now think it will not, that number would spiral upwards. To understand how high the number could go, we need to do some basic arithmetic on the government accounts.

National income or GDP breaks down into tax (40%) and disposable income (60%): assume that 50% accrues to non-taxpayers. Imagine now that GDP falls by 10%. This reduces tax takings by 4% of GDP, and also reduces disposable income. But as disposable income falls, the government pays tax credits (benefits) to the 50% not paying tax: assume their 50% of income falls by 5% of GDP and the tax credit rate is 80% as now promised in the government package.

Then government benefits rise by 4% of GDP. The total rise in the fiscal deficit is thus 8% of GDP when GDP falls by 10%. Now consider a lockdown lasting six months: that is half a year's GDP, a 50% fall on the year 2020 say. The resulting fiscal deficit would be 40% of GDP.

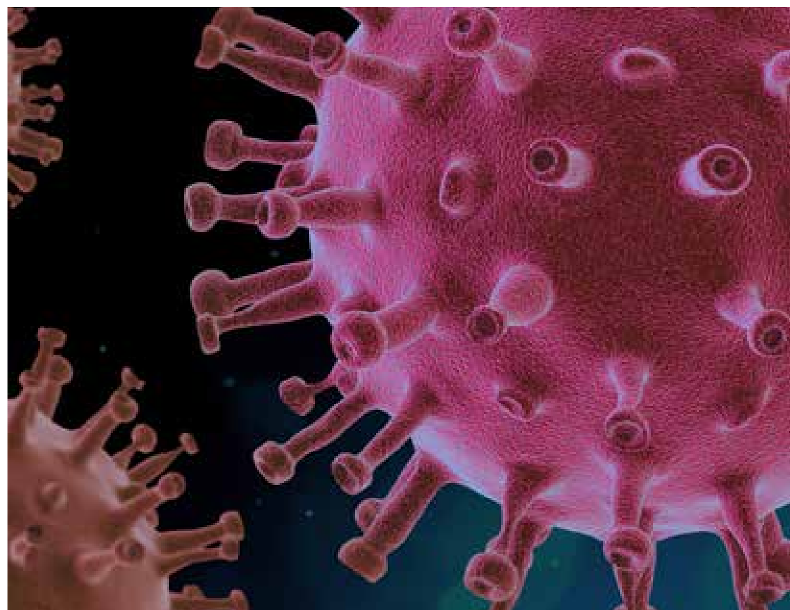
On top of the UK's existing public debt/GDP ratio of around 80%, this would take the UK ratio to over 100% of GDP, much on a par with the situation post WWII.

However, the government is greatly assisted by two interlocking factors. Interest rates today are nearly zero, with the yield on ten-year gilts around 0.4%. At the same time central banks are bound to help out during the crisis by buying gilts and printing money, keeping interest rates at this zero floor.

This implies that the government can borrow for next to nothing during the crisis and for very long maturities. But afterwards interest rates will rise as the economy recovers, and this rise will lower the repayment burden sharply.

To give an arithmetical example, with the UK government's current average debt maturity of 16 years, if the government borrowed £100 billion at today's rates of around 0.4% pa, its market value at post-crisis interest rates of say 5% pa would be only £50 billion.

This implies that future taxpayers are faced with a much reduced burden of debt to pay off: one can calculate the tax rate needed to pay the debt off as £50 billion times the new interest rate of 5%.



The longer the maturity at which the government borrows, the more favourable this arithmetic, which explains why the UK debt office has typically favoured long-maturity gilts.

Indeed, if it were to reissue all UK debt as indefinitely lasting coupon-paying perpetuities, then £100 billion of that issue would at a post-crisis interest rate of 5% fall in value to only £8 billion.

If we translate this into the need to pay off 100% debt to GDP contracted by the end of the virus crisis, it turns out the necessary tax rise is just 0.4% of GDP. This could be raised quite easily - just 1.3 pence on the standard rate of income tax.

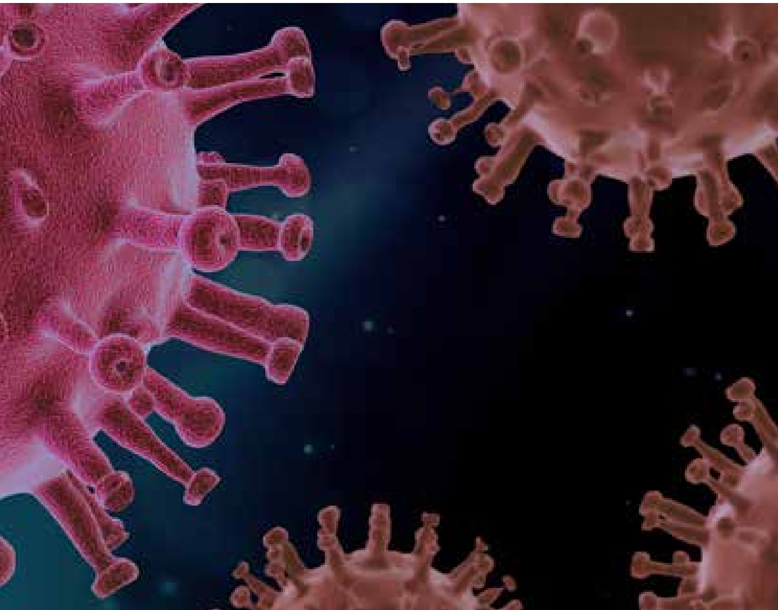
Another way of explaining this favourable arithmetic is to focus on the interest cost of all this debt after the crisis. The 100% of GDP in debt that would have been raised and rolled over before and during the crisis would have required an interest rate of around 0.4% pa. So the interest on it that must be paid by future taxpayers is very low.

One can see from this the powers governments have as monopoly raisers of taxes and printers of money. During crises when people have nowhere else to put their savings, governments can borrow easily as the only safe deposit show in town - the taxpayer sits at their back as repayment guarantee.

Meanwhile the central bank can print money, driving down rates of return on all assets, cheapening the cost of public borrowing.

What all this implies is that a sovereign government with a reliable taxpaying public is in a powerful position to cope with the financial fall out from wars and other fiscal crises.

Nevertheless, one must remember that to have a reliable taxpaying public one must have a functioning economy. That is why the most vital need in this crisis is to find a way to get people back to work, so the economy can revive.



How to handle fiscal and monetary policy after the crisis

Now turn to the moment the economy is released from the virus lockdown and starts to recover. Some commentators, notably those who adhere to 'Modern Monetary Theory' (in fact neither modern nor a coherent theory), have argued for continued monetary and fiscal stimulus, to push the economy all the faster to normal. They have suggested that this would run no risks with inflation.

However, this is bad advice. It is true that inflation has been quiescent for a decade while there have been substantial fiscal deficits in spite of austerity programmes while money has been printed on a massive scale by central banks through their QE programmes.

Essentially highly expansionary monetary policy has failed to prevent a world of moderate deflation. Yet it was a series of mistakes made by central banks that led to this outcome.

First, they fed a credit boom in the 2000s; then as bank balance sheets weakened with rising non-performing loans, they allowed Lehman to go bankrupt, precipitating the banking crisis. After the huge consequential bailouts, when bank credit needed to expand rapidly to create recovery, central banks brought in draconian new rules for banks that stopped them lending.

Their ensuing QE programme duly failed to trigger the upsurge in bank credit and broad money that was intended. Instead it drove interest rates down to zero and drove up other asset prices.

In the aftermath of the coronavirus crisis it is vital these mistakes are not repeated.

Coming out of the crisis, the government will hold large chunks of private equity. And banks will hold large portfolios of credit in private firms that have survived the crisis. In practice the draconian regulations restraining bank credit creation will have been lifted.

To prevent a huge surge in money and credit growth, the government must sell off its private equity stakes and central banks must sell off their massive holdings of government bonds to contract the money supply. This is necessary to prevent a serious inflation from taking hold.

With the government still running fiscal deficits until the economy recovers, there will continue to be substantial fiscal stimulus. With demand surging relative to a supply still getting going, prices will rise.

Provided money is kept under control, interest rates will rise as well, and we will gradually return to a normal monetary environment, with interest rates around 5% and inflation controlled at around 2-3% in line with the targets that central banks are committed to.

The final question to be answered is: how should fiscal policy progress after the crisis? I will use the UK as my illustration, but similar principles apply in all major rich economies.

Some illustrative figures can help us with our thinking. Plainly the UK government will emerge with a large debt/GDP ratio after the crisis package has been rolled out.

Our forecasts are that it will cost £300 billion overall, on top of existing debt of around 80% of GDP (which is around £2,000 billion), which we can assume is being refinanced at current low interest rates as far as possible. That would together imply a total debt of £1,900 billion at par having been issued by the end of 2020, 95% of GDP.

Let us assume as above that this debt will be rolled over into very long maturity at current low interest rates and that by 2022 interest rates have risen to about 5%, with gradually tightening monetary conditions. This would imply that at market value debt would only be some 10% of GDP.

What we are seeing here is that debt interest being so low on the debt that was issued, its being discounted at interest rates some ten times higher than at issue, its market value is greatly reduced.

These figures reveal that 'fiscal reentry' is reasonably manageable after the crisis. There will be those that will focus on the new high nominal debt/GDP ratio and urge austerity to bring it down. But they will be missing the point, imposing short-run fiscal rules that make no long run sense in the light of the very low long run interest rates at which the public debt will have been issued.

The UK Budget after coronavirus and Brexit

No budget is yet scheduled for when the UK has left the EU at year end and the economy will have recovered from the virus recession, as we currently forecast. However, it is necessary to focus on what should be in the next set of Budget plans.

In its election manifesto the Conservative party committed itself to following a fiscal rule for balancing the current budget by 2023. While that may have made sense as a tactical election decision to create clear blue water between it and

the reckless spending promises in the Labour manifesto, it creates a problem for post-Brexit fiscal policy in the current economic context.

The true cost of borrowing is now negative: in other words lenders are offering to pay the government to borrow from them. Furthermore, the reforms Brexit will bring in on trade, regulation and immigration promise faster future growth in the long term - even if most officials and the many private sector economists who backed Remain still take an opposing gloomy view.

Finally, there is a need for fiscal policy to give the economy a boost not just to put a firm end to Brexit uncertainty, but also to cut taxes to stimulate entrepreneurs, to raise essential spending on public services, and, last but not least, to push interest rates higher to a range where monetary policy can get traction again.

For all these reasons we need fiscal policy to become much more expansionary over the next decade. The tactical issue of how to square this with the manifesto commitment can in fact be dealt with quite easily, since the fiscal rules include the 'golden rule' that investment can be funded by borrowing.

What is 'public investment' is in the process of being redefined potentially in ongoing technical discussions within the government.

It has never made sense to limit it to infrastructure and other physical investment in this age where 'human capital' is ever more important: human capital is the discounted present value of people's productivity.

Much current government spending contributes to or directly creates human capital, notably the two big departments, health and education. Arguably most if not all public spending does, since its aim is to empower, train, and keep safe the country's population, so enhancing their ability to work and produce.

By redefining current spending on a par with investment spending, we can shift the focus of 'fiscal limits' to where they belong: the long-term sustainability of the plans for debt, spending and tax. In other words, are these plans consistent with solvency and the health of the long-term government balance sheet?

All these policy areas are at the heart of democratic decision-making, so to try and short-circuit decisions on them by imposing ad hoc short-termist operating rules is both lazy and damaging in the long term.

Let us therefore get back to the substantive issue of what fiscal policy should be and why. The most serious aspect of the situation we are in relates to the crisis of monetary policy, as noted above. With monetary policy powerless until interest rates get back up to normal levels where world savings do not dwarf world investment, we need a period where fiscal policy is highly expansionary, to shift the world balance back towards a savings shortage and drive up rates.

Fortunately this is the approach of the US government so far and looks likely to be that of Boris Johnson's government also. Fortunately again, there are now signs that German and so EU thinking is finally moving in this direction.

Now turn to what this Conservative government could do and the long-term prospects this could help unleash.

Our calculations suggest the government could spend or cut taxes by an extra £100 billion a year (about 5% of GDP) quite safely by borrowing more, and spreading it across personal and business tax cuts, and infrastructure spending.

According to our UK modelling, in the Liverpool supply side model of the UK, every 2% off the average tax rate, or equivalent cost reductions via public spending, gains 1% on GDP in the long run by making the economy more competitive. On this basis we could assess that this programme would raise growth by about 1% a year over the next decade and a half.

This would come on top of the gains from Brexit itself which we put at about 0.5% per annum. By achieving higher interest rates, the government would reduce the market value of its large existing, mostly long term, debt to a rather low percent of GDP as set out above.

What would this programme do to the long-term government balance sheet? By the end of the 2020 decade the debt/GDP ratio at market value would be well below today's level that is getting close to 100%, and would be around the 60% ratio usually regarded as safe.

The government, with a much higher GDP, would be spending 40% of GDP on programmes including debt interest, with tax revenues running at around a higher 41%. All this is highly sustainable.

It may well seem that the aftermath of the COVID virus crisis would not be a good time to launch such a bold programme. On the contrary, such economic uncertainty needs to be confronted with a strong fiscal stance, to ensure it does not become self-reinforcing.

The government needs to scotch all talk of new taxes, pledge to underpin the economy with any necessary borrowing in the short term, and chart a new course along the lines above to unleash the economy's long run economic potential. ■

Endnotes
1. https://voxeu.org/article/323-years-uk-national-debt

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Freedom during the COVID-19 crisis

Fleur de Beaufort and Patrick van Schie consider the measures taken to combat the pandemic and how state intervention can be reigned back

The world has been in the grip of the COVID-19 outbreak since early 2020. While initially, many aspects of the virus were still shrouded in uncertainty – with governments unable to make a sound assessment of its impact – by March, it had become clear that the world was facing a full-blown crisis.

Intensive care units rapidly filled up with patients and the medical care sector was overloaded with cases. Citizens started stockpiling en masse, and on 11 March the WHO officially characterised the COVID-19 outbreak as a pandemic.

Governments had to hastily determine which measures they needed to take to mitigate the crisis. And as the Dutch Prime Minister Mark Rutte reminded the press, they had to base their decisions on a very limited understanding of what they were actually up against. 'A veritable struggle,' as Rutte put it, that led to 'diabolical dilemmas'.

Around the world, it quickly became clear that it would be necessary to restrict people's freedom of movement in an effort to rein in the pandemic. At first, fear of the unknown virus and the mounting number of infections created widespread public support for all the emergency measures.

However, in the period that followed, we also saw new scope for reflection and criticism. Particularly now that in many countries, what has become known as 'the first wave' seems to have abated – and the associated, nation-wide panic with it – the adopted containment measures are the subject of heated debate. And almost everywhere, we can see certain groups resisting any form of intervention whatsoever.

Over the past months, different governments have also decided on radically different forms of 'crisis management'. Some governments opted for a total lockdown, during which almost every civic freedom was initially restricted in some way and citizens found in breach of regulations could count on hefty fines.

Schools and universities had to close their doors, working from home – wherever possible – became the standard, and citizens were generally expected to stay indoors as much as possible. Physical contact was kept to a bare minimum by government order, and in certain locations – nursing homes and care homes, for example – banned altogether.

The only stores allowed to stay open were those selling essential products – supermarkets, for instance. Many countries in Southern Europe adopted a total lockdown, but in Asia too, governments didn't hesitate to take the crisis as an opportunity to further strengthen their hold.

Other countries, in contrast, adopted a far less rigorous response. In some cases, in any case initially, this was due to the government underestimating the gravity of the situation – as witnessed in the US and Brazil.

In other cases – Sweden for example – the government consciously decided to let things run their course. While Sweden's citizens were advised to work from home wherever possible and keep travel to a minimum, its schools, hospitality venues and shops remained open. The Scandinavian country only prohibited gatherings of over 50 people, and care homes were also closed to the public.

During a press conference the Swedish Prime Minister Stefan Löfven announced that he trusted people to be responsible in their decisions. These were times, according to Löfven, when people not only needed to make sacrifices in their own interest but also for others' sake.

The Swedish government did not deem it necessary to legally enforce these sacrifices, pointing to people's personal responsibility to do the right thing.

In the meantime, the Dutch government had implemented what was known as an 'intelligent lockdown'. While this encompassed a large number of measures – a number of which were also enforced via emergency ordinances – the country consciously wasn't put into total lockdown.

Shops, for example, remained open and people working in essential occupations were allowed to drop off their children at school or childcare – albeit in limited numbers. And citizens could still relax in the outdoors – provided they continued to socially distance.

In the Netherlands too, the authorities appealed to citizens' sense of personal responsibility, although in terms of enforcement they wielded a bigger stick than their colleagues in Sweden.

Public support for the official COVID-19 policy tends to fluctuate according to the current crisis situation. In the Netherlands, for example, the government's measures initially enjoyed widespread support – in early March, many people even felt that the government could be more incisive in its response. Were we doing enough to prevent the virus from spreading? Or should we follow the example of our neighbours to the south and adopt far stricter measures?

As the country gradually brought the outbreak under control and the economic consequences of the intelligent lockdown came into sharper focus, public confidence in the government's performance as crisis manager diminished.

Reflecting on and criticising the government's handling of the corona crisis, people frequently draw comparisons with other countries. Opponents of far-reaching government intervention consistently point to Sweden as an example of how it should be done, while the media keep close tabs on this country's infection rate and death total.

A big risk of looking abroad for answers is that in many ways it amounts to comparing apples and oranges. After all, taken by themselves the COVID-19 data only tell part of the story. Other factors that play a key role in this context are the state of healthcare in the country in question (available care and, above all, IC capacity), population density, national character, etc. Aspects like these make drawing a direct comparison very difficult.

European liberals show a preference for the Swedish approach on ideological grounds. After all, citizens' individual freedoms and personal responsibility are two core values for this movement. At the same time, liberals also acknowledge the 'harm principle' as articulated by John Stuart Mill.

Over 150 years ago, the British philosopher worded this principle as follows in his work *On Liberty*: 'The only purpose for which power can be rightfully exercised over any member of a civilised community, against his will, is to prevent harm to others'.

In line with this principle, Rutte reminded the public during a press conference that one individual's freedom should not come at the expense of the other's health. In the present COVID crisis, this seems to open the door for a possible total lockdown.

After all, until we have developed a vaccine or effective treatment the potential risk of infection is such that people will continue to pose a threat to each other almost by definition. But is this actually the case? Since individual freedom is never entirely without risk, one could also make any number of other considerations.

For those who attach strong importance to individual freedom, restricting said freedom is not a step taken lightly – even during a pandemic. After all, as far as the concrete risk of infection is concerned, citizens do not all threaten their neighbours to the same degree.

A lot of people aren't infected with the virus – meaning they don't pose a threat to others. And among those who do contract it, quite a few don't suffer serious symptoms.

Moreover, greater freedom of movement for everyone does not preclude different considerations at the individual level. Anyone can decide for themselves whether they prefer to avoid large gatherings or physical contact with too many other people – or skip their annual holiday, for example.

Members of the various high-risk groups in particular will probably make different decisions than eg. young people, who feel more or less immune to this threat.

In organised societies, authorities are taking a variety of measures to minimise risks – health-related and otherwise – not least because of the impossibility of collectively bearing the possible consequences of inaction. It is vital to find the right balance in these endeavours.

Considering the number of people killed or injured in traffic accidents every year, those seeking an entirely risk-free society would be best served by far-reaching, government-imposed restrictions on road traffic. Nevertheless, no one would deem such a proposal realistic.

However, almost everyone accepts the legal requirement to wear a seat belt – a prescription that prevents numerous casualties – although this takes away the individual's freedom to make this particular risk assessment. In other words, it needs to be consistently evaluated which measures aimed at minimising a risk can still be considered proportionate.

"One thing's for sure: sooner or later, our citizens – as taxpayers – will be footing the bill for all the funds currently being doled out – seemingly free of charge"

An uncontrolled outbreak would put such pressure on the country's IC capacity that liberals will also agree to some measure of government intervention. However, the eagerness with which certain governments are seizing more power at the expense of individual freedom is unacceptable to liberals. After all, in times of crisis, individual freedom and people's individual responsibility remain as important as ever.

In the fight against COVID-19, an array of measures that reduce risk could be considered – isolating infected people, for example, protecting vulnerable groups who agree to this step, a temporary ban on large-scale public events like festivals or unnecessary travel abroad – while better safeguarding citizens' individual freedom. A freedom – and this we all understand – that will always entail some risk or other.

At first glance, this careful navigating between one person's individual freedom and risks to the other's health seems a temporary phenomenon. As soon as an effective vaccine or antiviral drug has become widely available, these deliberations will no longer be necessary.

We can return from the 'new normal' – as virologists and politicians have dubbed the current, rather inconvenient and unpleasant arrangements – to the one-and-only 'real' normal. At least, that's what you'd expect…

However, in the present public debate, quite a few people believe that we won't be going back to the way things were – or shouldn't. To start, there are those who believe that our behaviour will be structurally changed by our present forms of interaction.

This ranges from the idea that we will no longer greet each other in the same way – no more shaking hands, let alone kissing – to changes to our travel behaviour. In this outlook, we will be taking far fewer flights than we used to, for instance, which – as an added bonus – contributes to our efforts to combat the 'climate problem'.

From a historical perspective it does not seem very likely that human interaction will be structurally changed by the present crisis. After all, after previous pandemics like the plague or (as recently as the 20th century) the Spanish flu, people didn't keep more distance between them or seek each other out less often either. Human beings are highly social creatures who need to interact with others and who receive positive stimuli from these experiences.

Indeed, we can see in the present crisis how difficult it is for people – even with the threat of the virus still looming large – to keep the requisite distance. And this past summer, we saw how masses of well-to-do Europeans took a holiday abroad, viewing this as an inalienable 'right' – crisis or no crisis. Think what we like of such behaviour, the fact remains that human nature is unlikely to be changed by temporary threats like the COVID crisis.

What we could see happening is that working from home becomes a more common practice in occupations that allow for this. It will be necessary in that case to ensure that one still meets colleagues, clients, course participant and other work-related contacts face to face with some regularity.

It has become clear from the numerous Zoom sessions held over the past few months that while digital communication tools can be handy, they are also somewhat restricted. We will still have to meet each other in person every now and then. But it doesn't have to be every workday.

Now that it has become clear that employees can do a lot of work from home, we no longer have to submit to the 'daily grind' of commuting to and from the office five days a week. In this case, a change of behaviour is quite plausible because daily commutes were already considered inconvenient, due to wasted time and annoying congestion, for example.

From the very start of the COVID-19 crisis, there were also calls to grasp this pandemic as an opportunity to fundamentally change our way of life. For example, the outbreak was said to highlight the crisis that capitalism itself was going through. Or – under the motto 'never waste a good crisis' – it was seen as an opportunity to make thorough work of the 'climate problem'.

As was clear from the speed with which they were presented, these conclusions were hardly supported by a solid underlying analysis. Indeed, this call did not stem from a logical scientific inquiry into the issues at hand, but was made by a group of 'true believers' – be it in Socialism or in man's need to pay obeisance to the 'climate gods' – who latched onto the pandemic as a way to politically capitalise on their 'vindication'.

Was the pandemic caused by capitalism? Well, it actually originated in the world's foremost Communist dictatorship: the People's Republic of China. And that particular system also made things worse by attempting to cover up the outbreak for several weeks, and punishing whistle-blowers rather than giving them a fair hearing.

Is a Communist country like the PRC better able to combat the virus than a capitalist one? Well, in this respect, free China – Taiwan – has definitely outperformed its unfree counterpart on the mainland.

Nor could one say that free countries with stronger government intervention have done a better job. In Europe, countries like Italy, France and Great Britain with a nationalised system of healthcare have done worse than countries with a more mixed system.

This is not to suggest that there is a causal relationship as such, but simply that anyone who states that we will need to step up government involvement if we intend to weather the future will have to provide substantial evidence in support of this claim. For the moment, the opposite view seems to hold.

Nevertheless, one of the few structural changes that have come out of the COVID-19 pandemic seems to be increased state intervention in our economy. Across the planet, governments have come to the aid of citizens and companies with support measures large and small.

During major crises, governments need to offer temporary emergency aid. But at the same time, we have also seen how in the aftermath of the two major crises of the 20th century – the two world wars – it became next to impossible to once again dial back this extra state intervention.

While this will be applauded by some – the Socialist faithful, for instance – we fear that once we have overcome this pandemic, our societies will be continue to groan for far too long under governments that believe they can 'steer' and stimulate our economy.

One thing's for sure: sooner or later, our citizens – as taxpayers – will be footing the bill for all the funds currently being doled out – seemingly free of charge. ■

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To thrive in the post-COVID world, Europe needs a Plan B

Benjamin Zeeb is CEO of the Project for Democratic Union

Hailed as a bold move and new chapter in the EU's development, the COVID-19 rescue package still follows a logic that is doomed to failure.

On 5 August 1943, Jean Monnet declared: *"There will be no peace in Europe, if the states are reconstituted on the basis of national sovereignty... The countries of Europe are too small to guarantee their peoples the necessary prosperity and social development. The European states must constitute themselves into a federation..."*

But after the European Defence Community failed in 1954, Monnet took on a more practical approach, aiming to gradually integrate bits and pieces of national sovereignty until little was left for the state to decide over. Some in Brussels and Europe's capitals have taken this workaround as gospel and to this day misunderstand its intention.

The Methode Monnet was always intended to be directed at a final state of European federalization. It was never intended to be an endless process of baby steps aimed at an 'ever closer union' whose realization is projected into some distant past.

Europe paradoxically has come to fully endorse Monnet's Method, without approving its goal. Like a race car driver that is fundamentally and on principle opposed to reaching the finishing line, Brussels continues to make mockery of the man it holds in such high esteem.

This same mechanism is on display in the handling of Europe's latest crisis, one that once again requires the entire continent to act, when only few are capable and even fewer willing to do so.

Yes, a common debt is a step in the right direction, but what we are witnessing now is a far cry from the Hamiltonian moment required. Government by consensus rather than majority was never a great idea. In times of crisis it can prove fatal.

It is this lack of clarity and focus, this intellectual weakness, more so than any pandemic, that presents the largest danger to the European idea and by extension its citizenry. It could not come at a more critical time.

Across Europe, advocates of liberal democracy, rule of law, equality, solidarity, and free civil society have been pushed in a defensive position. The very same individuals and organisations who had traditionally been engaged in the drive to move the continent forward are finding themselves in the trenches of a hard-fought political, cultural, and ideological clash.

Rather than moving ahead, so it seems, in many European countries the order of the day has moved to defending what has been achieved in previous decades, by previous generations.

The classical divides between left and right, conservatism and progressivism, individualism and solidarity no longer apply. It is not only historians who are increasingly listening for the echoes of the 1920s and 30s in the speech, policies and demeanour of illiberal governments and movements around Europe.

Are we paranoid or is a second coming at hand? What if it is true that - in the words of William Butler Yeats - things are falling apart, the centre cannot hold, and a new rough

"If one wants to Europeanize executive power, this means that democratic process needs to be Europeanized as well"

beast is slouching towards Bethlehem to be born? Isn't it our responsibility then to try and kill it before it reaches its destination?

In this critical moment Europeans cannot leave politics to politicians alone. What is required is a strong civil society. This includes business and requires industry leaders to rediscover their sense of responsibility for the shared security and health of the continent.

What is happening here, too slow for many to catch on, has already happened elsewhere. And happened after business elites had failed to respond adequately to a moment in history that required more than just economic savvy.

The very same night that Donald J Trump was elected the 45th president of the United States, early trading on stock exchanges around the world saw prices plummet. The investor Carl Icahn, who was worth an approximate 20 billion dollars at the time, and a Trump supporter from the very beginning, left the election party before midnight. He went on a big shopping tour.

Unfortunately, he was only able to mobilize about one billion dollars on the quick, Icahn told the New York station Bloomberg TV later. Icahn, who would later become Trump's special advisor for economic reform, put everything he was able to scrape together into US stocks - and he turned out to be right. A year later, the S&P 500 had risen by almost a quarter.

One year later, the markets had learned their lesson. When the authoritarian right-wing populist Bolsonaro won the elections in Brazil last October, investors responded to the news with display of financial fireworks. What does this tell us about our economic culture?

At first glance it is not surprising that many business representatives shrug off the fact that Salvini is meeting with the PiS government in Poland, that Steve Bannon together with Gloria von Thurn und Taxis was mobilizing the conservative clergy against Pope Benedict, before being charged for fraudulent activities, or for that matter, that Cambridge Analytica, the dubious company that helped to win Trump the 2016 election, is also in contact with the heads of the Brexit campaign.

Populists, it seems, are good for business. But European industry, and Germans in particular, should be aware that an alternative to the post-war order is being created here. In this world, there is no room for the German business model.

All this requires a new radicalism in the strive for European unity that goes far beyond the tedious processes of the Methode Monnet.

The recent history of the European Union has shown that its members are extremely reluctant to cede sovereignty to the continental bureaucracy and until the creation of the Troika there was no governmental structure to be found anywhere in Europe that would have been worth the trouble for European federalists to even consider taking over.

Historically, nearly all political entities in Europe and elsewhere that successfully changed from authoritarian regimes or monarchies to democratically legitimated nation states achieved this by some sort of internal or external revolution.

Basically either the people took away political authority from those who had ruled them (as in France or in the US), or political authority was given to them by the victors following a conflict (as with Germany).

In nearly all cases, however, centralization had already occurred beforehand. It is hard to find cases in which stable democratic states have been established within a territory not previously consolidated.

However, European history also shows that suspending democracy, even for the briefest of moments is not a very good idea. Already Europeans don't trust the European institutions with the management of the rather mundane duties they are tasked with today.

How could we expect them to trust them with managing the fate of an entire continent? At times European elite's utterances seem to reveal the desire for a new kind of philosopher king that captures the minds of everybody walking the halls of the Berlaymont in Brussels.

Suspending national democracy is not an option until there are institutions in place and ready to take over as a functional equivalent. We cannot allow the state to crumble before we have a very clear gameplan for what comes next.

What we must push for instead is a one single and well-prepared moment of parliamentary fusion, that ensures continued representation and guarantees that democratic accountability remains in place.

This will necessitate something many dread, an element of direct democracy. Simultaneous referenda in all member states and regions of the eurozone that will determine whether or not a country or region joins the new federal Union. The new Union will then be constituted the very same moment in which two or more entities decide to join it.

A European Union that continues to rely on structures that are built from the top down, whether this affects all members at once or only a handful at a time, especially if it doesn't grant citizens the power to collectively decide on varying policy ideas, will never be stable.

If one wants to Europeanize executive power, this means that democratic process needs to be Europeanized as well. In the end, whether or not a state's citizenry is willing to make this change, should be where the line is drawn. ■

Is BRICS past its sell-by date?

Elizabeth Sidiropoulos is the Chief Executive of the South African Institute of International Affairs

The demise of the BRICS based on its apparent incoherence has long been predicted by pundits. But as Mark Twain observed about reports of his death being greatly exaggerated, so too the BRICS have defied the critics.

They have created BRICS institutions (the New Development Bank and the Contingency Reserve Arrangement), which serve to cement the body, and are now in their second decade. But are these institutions sufficient, and are the growing tensions among the great powers making the BRICS more necessary or less coherent? Is BRICS past its sell-by date?

When the BRIC forum met for the first time in 2009, its leaders affirmed their support for a 'more democratic and just multi-polar world order based on the rule of international law, equality, mutual respect, cooperation, coordinated action and collective decision-making of all states'[1]. It did not expressly define itself as anti-western, although it was non-western and a Global South grouping (despite Russia's membership).

Meeting at the height of the financial crisis, which had its genesis in the US, the BRIC signalled the ambitions of rising (or re-emerging) powers to increase their voice and influence in international affairs and global governance, especially in the international financial institutions, which needed to reform to reflect the changes in the global economy.

With the addition of South Africa in 2011 the grouping could boast members from each of the world's developing regions.

The outbreak of the financial crisis in North America and Europe was a watershed moment in the power shifts that had already been evident since the turn of the century. It showed that the west was not economically invincible, nor that it had all the answers for development.

The west's own rising inequality within its societies and its negative consequences for democracy seen in the rise of populism and ultra-nationalism also opened it up to critique of its own political systems.

Traditional western alliances have frayed under President Trump. A Biden presidency may help to revive them, but there is no going back to the status quo ante Trump. Since Trump became US president, the Thucydides trap looks much more likely. A rising power, China, is threatening more than ever to displace an established one, the US. And the escalating tensions between the two make conflict a possibility, even if neither wants it.

Meanwhile China's Belt and Road Initiative (BRI) has grabbed the imagination of the developing world and many in Europe too – all while its campaign against the Uighurs in Xinjiang and the Hong Kong demonstrators protesting against the new security regulations show the other side of China, not the champion of economic development, but the authoritarian Chinese Communist Party that brooks no dissent.

In 2009 when the BRIC held their first summit, China still ascribed to the dictum of 'hide your strength, bide your time, never take the lead'. This changed under President Xi Jinping. The time for hiding China's strength and ambitions is over.

The truth is that BRIC(S) were always about China and the rest. The BRICS' potential political and economic importance lay in the fact that China was a member. If China was not a member, the BRICS might have been another IBSA. Over the short to medium term, China's growing global ambitions will affect how it perceives the BRICS in the hierarchy of its membership of various groupings or initiatives, such as the Shanghai Cooperation Organisation or the BRI.

Other members have also undergone significant changes. In India, Prime Minister Modi has moved closer to the US and embraced the concept of the Indo-Pacific, which is driven by an underlying objective to contain Chinese influence. Since he came to power Modi has both cultivated ties with China and not been shy to challenge it on the border, whether in the Doklam plateau in 2017, or in the Galwan Valley earlier this year.

Their differences do not necessarily mean that the two cannot cooperate inside the BRICS on issues of common interest, but if the border disputes and tensions continue to increase, the room for political consensus within the BRICS may narrow. It may also force the others to take sides.

In Brazil the new president, Jair Bolsonaro, has a strong anti-China rhetoric and an affinity for Donald Trump. Unlike his

'As the global power shifts begin emerging more clearly, the BRICS will continually reassess their positions and how the grouping hinders or advances their goals"

predecessors from the Workers Party, Presidents Lula da Silva and Dilma Rousseff, Bolsonaro's natural foreign policy preferences are to the west, not the Global South, even though China remains an important trading partner.

Russia, where President Putin remains firmly in power, is both threatened by China and recognises it as a necessary ally in its own rivalry with the US. One Russian scholar argued recently[2] that China's siding with the US in the Cold War 45 years ago was 'one of the most important external factors in the defeat of the USSR'.

Russia's partnership with China would not only alter the dynamic along Russia's longest border, but could also help Russia achieve its own foreign policy goals vis-à-vis the west. Russia has long considered the BRICS as a potential anti-western grouping, an aspiration that was never really shared by the other members.

The outlier among the BRICS is South Africa. Ever since the country joined, the BRICS has been given prominence in its international relations as well as in its interdepartmental coordination at home.

Although president Zuma was replaced by President Ramaphosa in 2018, South Africa's foreign policy orientation has not changed. Relations with China in particular continue to be important as does the BRICS.

In 2019 South Africa's foreign minister, Naledi Pandor[3], emphasised at a BRICS meeting in New York, that the BRICS were coming together at a time 'when the international community requires an alternative narrative to global issues'.

She went on to say that the BRICS had to 'maintain our role as leaders on a path to a more balanced, representative and equitable international order'. But is the grouping what some saw it as, at the vanguard of systemic reform?

What is increasingly clear is that the BRICS don't share a common vision of what a new world order will look like, although they emphasise the importance of multilateralism. Two members, India and South Africa, are part of the Alliance for Multilateralism[4], which was initiated by Germany and France in 2019. None of the others are.

Earlier this year, two leading Russian scholars proposed[5] that Russia become the guarantor of a new non-alignment and that together with the BRICS and the Shanghai Cooperation Organisation (SCO) it consider establishing a Global Alliance for Sovereignty and Diversity. Russia does not consider itself a follower, but a great power with an independent foreign policy.

As for China it is becoming increasingly clear that it no longer is concerned about diffusing its power through bodies such as the BRICS. It is growing in international confidence to project its military power and its political influence in multilateral bodies.

Furthermore, the New Development Bank was touted as a new innovative instrument that would do things differently from the traditional multilateral development banks, but its approach has been rather orthodox.

The countries have also not stepped up as a collective in the wake of the COVID-19 pandemic. Four of the five have had among the highest number of cases, and China was where the virus was identified first.

China's mask diplomacy has won kudos, but its opaqueness on the issue of debt service rescheduling for the poorest countries has been less endearing. While there were opportunities for BRICS health diplomacy outreach to developing countries, assistance was bilateral rather than collective.

The Trump presidency in the US from 2017 onwards escalated the rivalry between it and China, and this matter now occupies the international agenda, manifesting itself in the first instance through the US-China trade war which is primarily about technological supremacy.

It is how the other BRICS line up in the technology wars over 5G that will highlight the growing security differences and coherence gaps among them. India[6] will not allow Huawei and ZTE to participate in its 5G trials.

On the other hand, there is a tension within the Brazilian[7] administration about whether to allow them to tender. President Bolsonaro supports the US position to steer clear of Chinese companies, but Huawei has not been excluded from participating in the bidding.

South Africa has clearly set out its position that it favours Huawei, with President Ramaphosa emphasising at a 4IR conference in 2019[8] that *"We support a company that is going to take our country and indeed the world to better technologies, and that is 5G. We cannot afford to have our economy to be held back because of this fight [between China and the US]."* Russia[9] has equally indicated that it is ready to cooperate with Huawei on 5G technology.

So not all the BRICS are geopolitically aligned, if their technology preferences are a proxy for the coming contest.

Yet, for each member the BRICS is useful in different ways. China still sees it as one of a number of platforms to project its influence on the global stage together with four other politically important countries in their regions. Some three years ago, before the Xiamen summit, China proposed a BRICS Plus arrangement.

In announcing this, President Xi said that BRICS was more than its current five members. Cooperation with other emerging market and developing countries was an important

dimension of the BRICS. While not a formal expansion of the group, it illustrated China's strategy of developing a network of informal alliances across the developing world (but not only), as its global influence continued to rise.

Its strategy with the BRI summits fulfils a similar goal as does its membership of organisations such as the SCO. However, what is sometimes overlooked is the disquiet China's rise elicits among other Global South powers, not least those in Asia.

For Russia this informal grouping provides it with support in its tensions with the west and at least tacit support, for its own ambitions. While wary of China's rise that inevitably will make Russia a junior partner, it can still derive geopolitical advantage vis-à-vis the west through its membership, especially after it was uninvited from the G8, after the annexation of Crimea.

In South Africa's case, its increasing competition with other African countries such as Nigeria, Kenya and Ethiopia, its membership of the BRICS allows it to stand out from the rest.

South Africa has placed economic opportunities as one of the central reasons for the importance of the BRICS, but China is the dominant economic partner for South Africa, without much progress in increasing the economic links with the other three. But what about Brazil and India? Under president Bolsonaro, the BRICS has not had much political prominence in Brazil, but it would be unlikely that it would leave it when it still has a large trading relationship with China.

In India's case, the tensions with China have been there before, but its presence in the BRICS elevates its global profile. For all China's strong links to Pakistan, India's presence in the BRICS sets it apart its nemesis, sitting as it does in a forum with Pakistan's closest ally.

Therefore, for each BRICS member the grouping serves certain elements of its foreign policy. Even though China is growing in strength and power projection, an issue that not all of the BRICS are comfortable with, none of them considers this development to signal an end to the BRICS utility.

Some, like Russia, have an explicit anti-west agenda; others such as India and South Africa are proud of their Global South and democratic credentials, and do not see the world through Russia's lens, while Brazil under Bolsonaro is perhaps the most explicitly pro-western.

As the global power shifts begin emerging more clearly, the BRICS will continually reassess their positions and how the grouping hinders or advances their goals. It will be less about advancing collective action and more about instrumentalising it for individual gain. ■

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Limits and pitfalls of QE in emerging markets

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The pandemic caused by COVID-19 has shocked the whole world and is another huge blow to the world economy after the financial crisis that erupted in 2008. A sanitary crisis is interweaving with a very severe economic and social crisis.

Although most economies seem to have got out of the deep hole caused by The Shutdown, a steady recovery is likely to be difficult and painful, surrounded by big uncertainties and contradictory effects.

Much of economic activity is badly hit, not a few companies may not be able to survive, unemployment has been growing rapidly[1], and repair efforts will be time consuming.

In advanced economies (AEs), governments and central banks have unleashed massive support programs. In the US, for instance, the fiscal and monetary support goes beyond that seen during the Great Recession.

The Fed's intervention in markets is stunning in its depth and breadth, with its balance sheet jumping from over $4 trillion to over $7 trillion this year, and more is probably to come; even junk assets, fallen angels, are liable for acquisition.

In Europe, the ECB has extended its non-conventional operations, while a European recovery plan that amounts to €750 billion, will supplement the EU budget for the period that starts in 2021. As a novelty, the plan will be funded by the issuance of collective EU bonds. All in all, budged deficits have skyrocketed worldwide, as during war times.

Apart from the dire conditions entailed by the pandemic and the economic crisis, an intellectual context favours rising fiscal support. The apparent decline of the natural interest rates in recent decades[2] and very low inflation after the financial crisis seem to prompt governments to rethink allegedly dangerous thresholds for public indebtedness.

Kenneth Roggof and Carmen Reinhart's upper level of 90%[3] may no longer be seen as a discouraging barrier. Olivier Blanchard talks of a new normal (a new regime) for monetary policy by considering lower debt servicing costs when interest rates are inferior to economic growth rates[4], a view that is echoed by Paul Krugman[5] and others.

Kenneth Rogoff argues in favour of deeply negative policy rates as an alternative to large scale QE, which itself is a form of financial repression; he says that such a policy would be a huge blessing to EMs that are plagued by falling commodity prices, fleeing capital, high debt and weak exchange rates[6].

Proponents of the New Monetary Theory argue openly for monetizing fiscal deficits provided inflation is under control[7]; their line of reasoning can be bolstered by the desire to reverse very low (or declining) inflation expectations (the threat of debt deflation) and the extraordinary nature (once in a lifetime) of the coronavirus shock and the related economic and social crisis.

This is the context which made some to examine the feasibility of QE[8],the injection of base money against financial assets, even monetization of budget deficits in emerging economies/markets (EMs).

As a matter of fact, elements of QE are practiced in a series of emerging economies. In Colombia, Indonesia, Poland, Hungary, Thailand, among others, central banks do it. But the size of their programs is significantly smaller than what the Fed, BoE, the ECB and BOJ, etc[9].

Why is it so? The crux of the matter is that QE in emerging economies can be pretty tricky and littered with pitfalls. The view that a 'silent monetary policy revolution' is taking place in emerging economies, in the sense of undertaking QE like in advanced economies is an overblown assertion[10].

Where QE is done in EMs, it takes place as a sort of 'free riding' on the wave of QE in AEs, but not without limits and risks.

There are basic differences between emerging and advanced economies, which asks for caution in judging QE in the former:

- Emerging economies do not issue reserve currencies. This dents the efficacy and autonomy of monetary policy in dealing with severe shocks;

- For not a few EMs there is an issue of institutional credibility and track record in subduing inflation and deficits;

- Monetary policy, as a plus in a policy-mix framework, can be weakened by the exchange rate risk, by insufficient trust in the local currency;

- The volatility of exchange rates in emerging economies does matter, the more so where dollarization/euroization is high[11].

  A flexible exchange rate can help in correcting imbalances, but it can also do harm when a massive depreciation entails substantial wealth and balance-sheet effects, intensifies currency substitution, and may cause inflation to get out of control. A brutal drop of the local currency value can cripple financial stability;

- Local financial markets are frequently quite thin and cannot absorb large issuances of sovereign debt. The exposure limits of commercial banks to local government debt are to be considered as well;

- Although issuing debt in local currencies is preferable[12], a small size of local financial markets can force the issuance of bonds on external markets. And this creates a major vulnerability related to exchange rate dynamics.

  In addition, unless deficits are not perceived by financial markets as reasonable, their funding can be drastically limited and sudden stops can ensue;

- For the EU weaker economies, the free movement of capital can be a headache in moments of market panic.

  This has been glaringly shown by substantial flow reversals during the euro area crisis, when money took a flight from South to North; or outside the euro area, when capital sought to flee new member states, which was a reason for the Vienna Initiative to be enacted in 2009;

- Sudden stops can take place in emerging markets even when global financial conditions are relatively benign;

- QE in advanced economies can induce EMs to borrow too much as hot money is searching for higher yields. And when conditions change, larger debts may find their servicing jump quite highly and turn very costly;

- It is not clear whether macropudential policies to deal with large capital inflows and outflows can be effective enough. As a matter of fact, a paradox operates here: QE in AEs may foster a temporary more benign global environment that helps ease monetary conditions in EM too.

  But this can easily turn out to be a nuisance in disguise to the extent there is much over-borrowing (like after the Great Recession) and capital flows reversals harm weaker EMs[13].

“The crux of the matter is that QE in emerging economies can be pretty tricky and littered with pitfalls. The view that a ‘silent monetary policy revolution’ is taking place in emerging economies, in the sense of undertaking QE like in advanced economies is an overblown assertion”

The features highlighted above indicate constraints for monetary and exchange rate polices in EMs and, consequently, for QE programs.

Emerging economies that have been quite successful in reducing dollarization/euroization of their domestic transactions, where internal and external deficits are under control, with considerable sovereign bonds issued in local currency and plentiful foreign exchange reserves, can be more daring in practicing QE.

They could also benefit on backups, such as swap and repo lines arranged with reserve currency issuers, like the Fed and the ECB. This room of manoeuvre concerns the flow of liquidity on domestic markets and preventing excessive yields demanded by foreign lenders/inevstors (via asset purchases by local central banks on secondary markets), the easing of policy rates and of overall monetary conditions when interest rates fall in the global economy.

But QE and monetization of deficits are fraught with major risks wherever deficits are large, external debts are considerable, and trust in the local currency is not sufficient.

The case of EMs in the EU deserves attention for some of them have undertaken parts of QE. Among new member states which joined the EU in 2004 and 2007, Poland has announced a QE program that could go up to 5-6% of GDP this year, while the budget deficit could reach more than 8% of GDP. Hungary has a significantly smaller QE program as the budget support for its economy relies extensively on guarantees.

Both these countries have started the war against the COVID-19 pandemic with much smaller domestic and external imbalances and significantly lower euroization of the financial system than Romania. The Czech Republic is quite a peculiar case for the high trust the crown enjoys among its citizen. Sovereign ratings illustrate macroeconomic situations[14], and the cost of issuing debt is indicative of national economic circumstances.

Thus, Romania pays almost double for issuing debt in local and external markets, as compared to Hungary and Poland, not to mention the Czech Republic; CDS term premia are also telling in this regard. Hungary and Romania have repo arrangements with the ECB, whereas Bulgaria and Croatia benefit on swap lines as they entered ERM2 in June this year.

These arrangements are a plus in dealing with possible liquidity squeezes in financial markets. The EU budget funds, together with the European recovery plan, help considerably the fight against COVID-19 and economic reconstruction.

Yield differentials for sovereign bonds and CDS term premia show that markets discriminate among EM, despite the easing of monetary and financial conditions worldwide.

Therefore, caution must operate when contemplating dealing with the pandemic and the economic crisis by resorting to large fiscal stimuli and aggressive easing of monetary policy, to QE and monetization of deficits. The countries that have fiscal space can be more daring in this regard, but not without caution.

In the EU, fiscal rules are temporarily suspended, but markets do discriminate and judge economies according to their robustness, the capacity to absorb shocks, whether backups (as safety nets) are available.

In the euro area, the debt servicing costs for more fragile economies hinge basically on the ECB support, which has saved the single currency via its unconventional operations, including QE. In the global economy, instead, there is no automatic support, in spite of massive operations undertaken by the IMF to support emerging and poor economies.

In the Romanian case, the issue is not the stock of public debt, that was cca. 35% of GDP last year. It is a flow problem, that is rooted in a large structural deficit (above 4% of GDP at the start of 2019) and big pressures to increase permanent public budget expenditure while fiscal revenues are pathetically low (cca. 27% of GDP); there is also a twin deficit problem involved here.

This creates a big policy conundrum since, on one hand, the room of manoeuvre to combat the pandemic is severely curtailed and, on the other hand, there can be considerable depreciation pressures on the exchange rate which enhance inflationary expectations (as the pass-through effect is non-trivial).

A significant rise in permanent budget expenditure would worsen even more the structural budget deficit, it would imperil Romania's investment grade rating and entail a significant rise in the cost of debt service, in the public debt[15].

This would invalidate a key assumption of the new normal for monetary policy in the Blanchard logic (see footnote 3), namely a low interest rate (r) level. And if the economic growth rate (g) falls significantly, apart from an allegedly temporary impact of the pandemic[16], and in conjunction with a sizeable primary (and structural) budget deficit, one ends up with a reinforced invalidation: while (g) comes down, (r) goes up when the primary deficit is considerable and on the rise.

A correction of macroeconomic imbalances has to be undertaken in Romania in the next few years, which will be a pretty tough operation in view of the impact of the sanitary

and economic crisis. This situation explains why the Romanian central bank cannot be as aggressive in reducing its policy rate as its peers in the Region, and why it cannot embark on a QE program per se[17].

For it may undermine the trust in and trigger a run on the local currency, ultimately damaging financial stability. If markets would perceive that there is monetization of the budget deficit on a large scale, a crisis of the local currency would be quite inevitable.

The correction of the large structural budget deficit, be it done gradually (so that it does not cripple a tenuous economic recovery after the lockdown) has, therefore, to play a critical role in reducing macroeconomic imbalances. This correction can be much facilitated by EU funds that can uphold public expenditure and help fund external deficits.

Is financial repression the exit out of the current situation with rapidly growing public debt worldwide, as Carmen Reinhart and Sbrancia suggested by referring to the second world war period and its aftermath in the US and Europe?[18] Prima facie, this seems to be the case in view of the staggering rise in public and private debts following the financial crisis and, currently, because of the pandemic.

QE is a form of financial repression as governments try to control the yield curve by purchasing sovereign bonds (and, thereby, by reducing the cost of budget funding) and other financial assets, by going beyond what can be seen as market-making (repair) in periods of distress. But even in AEs financial repression may be difficult to achieve when inflation is very low, which would imply negative nominal interest rates.

And how sustainable are negative interest rates over the longer term is an open question, although Japan provides food for thought in this respect (as well as to the secular stagnation thesis, the Japanization syndrome).

In some new member states, which have experienced labour markets strains for years now (due to massive labour emigration), where the Balassa-Samuelson effect may be larger than some suspect, and where exchange rate dynamics have probably also played a role, inflation is quite considerable – between 3-4% lately in Hungary, Poland, Romania, etc.

When inflation is substantial and currency substitution is an issue, capping interest rates may be risky. The bottom line is that rapidly increasing public debts should not leave us unnerved, be the natural interest rate much lower than a few decades ago[19].

QE may have merits as a means to avoid a lasting depression and, in the euro area having helped to save it, but it is unclear whether it can be the final solution to debt sustainability.

Some may argue that nothing seems to be like before, that economics enters a new 'stage' and that old tools are no longer reliable, that emerging economies should do whatever advanced economies do policy-making-wise. But this is hardly a convincing argument.

The size of public and private debts and of structural deficits do matter, as do economic fundamentals, degrees of wealth and robustness (vs. fragility), policy track records, availability of backups and 'friendly' neighbours, or membership in clubs like the EU and the euro area.

Balance of payments crises will not disappear, and defaults will continue to take place, especially among EMs. Sudden stops can also occur. This is why caution is warranted in EMs in trying to mimic QE as practiced by AEs. For emerging economies, there are limits and pitfalls in undertaking QE[20].

As Agustin Carsten put it, *"fiscal sustainability should be assured, otherwise perceptions may arise that debt can be inflated away"*...and *"crossing the traditional boundaries between fiscal and monetary polices, are only feasible for central banks in advanced economies with high credibility stemming from a long track record of stability-oriented policies."*[21]

A final thought on QE: QE may be useful, indispensable, wherever avoiding a collapse of economies (of financial sectors) is aimed at. But to claim that this is the way to remake the toolbox of central banks radically, for the long haul, is a bold statement.

As a matter of fact, QE is more like 'kicking the can down the road', and it reflects, arguably, an inability to tackle fundamental issues related to resource allocation[22], taming the global financial cycle, over-financialization of economies and feeble restructuring (zombification of many parts of economies), increasing income inequality, etc.

If this is the case, QE in EMs cannot be but a pale side of this state of affairs and can, in no way be an actual breakthrough in policy making.

Moreover, QE, as sort of prolonged crisis management component of monetary policy, has to be examined in a deeper sense: how economies can be remade in order to become more robust/resilient, more inclusive and fair, with an overhauled financial sector that should cater more to the needs of the real economy, antitrust laws that impede abusive concentration of market power, effective fight against tax evasion and avoidance, revamped tax systems that are more equitable, reinstating a sense of genuine ethical conduct in the corporate world, combating climate change which has become an existential threat to mankind, and avoiding a complete collapse of multilateral arrangements in the global economy. ■

This is an expanded English version of the article "QE in emerging economies: beware of traps" [http://www.opiniibnr.ro/index.php/english/443-limits-and-pitfalls-of-qe-in-emerging-markets-i], which was published in Romanian by Opinii BNR, 1 July 2020. The views expressed do not necessarily represent the position of the institutions the author is affiliated with.

Endnotes

1. An acute social problematique is unfolding, that will be reinforced as temporary relief measures for jobless workers will end. 'Kurzarbeit' type schemes may not be sufficient to mitigate the social impact of this crisis (see also Carmen Reinhart and Vincent Reinhart, "The Pandemic Depression. The Global Economy will Never Be the Same", Foreign Affairs, September/October, 2020). This explains why some countries (Finland, Germany, etc) experiment with minimum guaranteed incomes. The social dimension of the Covid-19 crisis is recurrently highlighted by the managing director of the IMF, Kristalina Georgieva; this dimension should be examined in relation with an ever more skewed income distribution in recent decades, the erosion of the middle class, the declining power of labour (see Anna Stansbury and Lawrence Summers, "The declining worker power hypothesis", NBER Working Papers No.27193, May 2020), declining social inclusiveness, the impact of artificial intelligence. In poor countries things will get ever worse because of the crisis, and IFIs and the international community need to step in to prevent sovereign debt crises in a row (see also Joseph Stiglitz and Hamid Rashid, "How to prevent the looming sovereign debt crisis", Project Syndicate, 31 July, 2020).

2. Mervyn King and David Low, "Measuring the World Real Interest Rate", NBER Working Paper, No.19887, 2014; Kathryn Holston, Thomas Laubach and John Williams, "Measuring the Natural Interest Rate: International Trends and Developments", Journal of International Economics, 108, January 2017 (by using the model used by Thomas Laubach and John Williams (2003) they show that the rate seems to have fallen close to zero in the US during the financial crisis and stayed there since 2016); Rachel Lukasz and Thomas Smith, "Secular drivers of the global interest rate", BoE, Staff WPs No.571, 2015. See also Larry Summers on secular stagnation, "Reflections on the New Secular Stagnation Hypothesis", in C Teulings and R. Baldwin, "Secular stagnation: facts, causes and cures", VoxEU.org EBook, CEPR Press

3. Kenneth Rogoff and Carmen Reinhart, "This Time is Different. Eight Centuries of Financial Follies", Princeton University Press, Princeton, 2011

4. Olivier Blanchard, "Public Debt and Low Interest Rates", American Economic Review, 109(4): 1197-229. Basically, the argument is that when economic growth rates are higher than interest rates, governments can run primary deficits without endangering the state of public finance and welfare as long as public debt as a share of GDP stabilizes; this can be summed up as (r – g) being negative, where (r) is the interest rate and (g) is the economic growth rate (both rates can be in nominal, or real terms). See also O Blanchard, A Leandro, and J Zettelmeyer, "Revisiting the EU fiscal framework in an era of low interest rates", 30 January, 2020. For a much less sanguine view on this scenario see Charles Wiplosz, "Olivier in Wonderland", CEPR, VoxEU, 17 June 2020

5. Paul Krugman, "The Case for Permanent Stimulus", VoxEu, 10 May 2020

6. Kenneth Rogoff, "The Case for Deeply Negative Interest Rates, Project Syndicate, 4 May, 2020

7. William Mitchell, Randall Wray and Martin Watts, "Macroeconomics", London, Red Books, 2019. See also N Gregory Mankiw, "A Skeptic's Guide to Modern Monetary Theory", American Economic Review, May, 2020, pp.141-45

8. QE is not to be equated with normal capital markets operations, as they take place in EMs as well.

9. An IMF document says that "Among the 81 economies classified as EMs, 55 took measures to support financial markets during the COVID-19 pandemic…as central banks aimed at easing pressures in short-term funding markets. However, EMs intervened more in FX markets than AEs reflecting partial dollarization and capital outflows. EMs seldom intervened in securities markets, reflecting the bank-centric nature of their financial systems" ("Central Bank Support to Financial Markets in the Coronavirus Pandemic", IMF, MCMCO, 2020, p.6)

10. Piroska Nagy-Mohacsi, "The Quiet Revolution in Emerging Market Monetary Policy", Project Syndicate, 18 August, 2020

11. Agustin Carstens , the head of BIS, notices that "…emerging market economies have a quasi-managed floating exchange rate regimes where central banks lean against swings in the exchange rate, both on the way up and on the way down….this approach is one where the practice outruns the theory and it is arguably the theory that needs to catch up". This is because "…the behavior of the exchange rate can fundamentally affect the dynamics of inflation and the capacity of monetary policy to produce the expected results"(Exchange rates and monetary policy frameworks in emerging market economies", Lecture at the London School of Economics, London, 2 May 2029

12. But even issuing debt in the local currency and selling it to non-resident investors can create an implicit debt-rollover risk", named as the original sin 2.0." During periods of higher risk aversion, when local currencies are under pressure and domestic assets are sold off, foreign investors are likely to reduce their exposure and might not roll over maturing positions("Managing volatile capital flows in emerging and frontier markets", Reinout De Bock et.al. VoxEu, 19 August 2020).

13. Andrea Presbitero and Ursula Wiriadinata rightly argue that although interest rate-growth differentials (r – g) have turned negative in many countries, which may facilitate fiscal expansions, there can also be (r-g) reversals when public debts grow massively and much of these debts are denominated in foreign currencies. Clearly, the specter of substantial currency depreciation, the exchange rate risk, is involved in such dynamics ("The risks of high public debt despite a low interest rate environment", VoxEU, 5 August 2020).

14. The Czech Republic has AA-, Poland has A-, Hungary has BBB, while Romania is rated BBB- by S&P.

15. Eurostat figures show that, before the pandemic struck, Romania was the only EU member state where public debt as a share of GDP was rapidly growing in the absence of fiscal consolidation measures: from cca 35% in 2019 to 62,3% in 2025 and to 91,2% in 2030 ("Debt Sustainability Monitor 2019", European Commission, Brussels.

16. More likely is that the COVID-19 crisis and the related economic and social crisis will reduce potential economic growth in most economies.

17. As a matter of fact, the NBR has become a net creditor of the banking sector since March this year, via irreversible operations as a means to stem depreciation pressures on the Leu (the local currency). But the loss of net foreign assets could not continue indefinitely, which shows why fiscal consolidation is a must in the not too distant future.

18. Carmen Reinhart and M Belen Sbrancia, "The Liquidation of Government Debt", IMF Working Paper, January 7, 2015

19. See also Anne O Krueger, "Financial Repression Revisited?", Project Syndicate, 20 August 2020

20. "QE appears to be a viable macroeconomic policy response to COVID-19 for countries with a credible institutional framework in which the central bank operates a floating exchange rate regime and the sovereign issues debt in its own currency" (G Benigno, J Hartley, A Garcia-Ferrero, E Ribakova, "Credible emerging market central banks could embrace QE to fight COVID-19", VoxEu, 29 June, 2020. But this assertion has to be qualified when structural deficits are large and currency substitution is significant (the issue of trust in the local currency).

"When hit by a crisis, economies with less credible monetary frameworks and weaker fundamentals my find themselves between a rock and a hard place. Capital outflows can put heavy pressure on the exchange rate, with the twin risks of a disorderly adjustment (currency crisis) and a persistent upsurge in prices (if inflation expectations are poorly anchored and pass through from the exchange rate is high"(Gaston Gelos, Umang Rawat and Hanqing Ye, "'COVID-19 in emerging markets: Escaping the monetary policy procyclicality trap", VoEU, 20 August 2020.

21. Agustin Carstens, "Countering Covid-19: The nature of central banks' policy response", BIS Speech, Zurich, 27 May 2020

22. As BIS experts stress, The Great Moderation years hid huge resource misallocation (Jaime Caruana, "Stepping out of the shadow of the crisis: three transitions for the world economy", BIS Speech, 29 June, 2014). Overburdened monetary policies during the past decade can be compared with monetary policies in post-command economies. Following the collapse of the command system and a dramatic change in relative prices, many enterprises became unprofitable. Massive and rapid resource reallocation was impossible. Thence the need to subsidize firms and even sectors involving monetization of quasi-fiscal deficits. Firms themselves created an own pseudo-money via inter-enterprise arrears (Daniel Daianu, "Inter-enterprise arrears in post-command economies, IMF Working Papers, 74, 1994 and "Resource misallocation and strain. Explaining shocks in post-command economies", William Davidson Institute WP, No.96, 1997)". The quasi-fiscal task of central banks during the initial stage of post-command transition is to be compared with QE practiced by major central banks in advanced economies – where a similar fiscal dominance takes center stage. But inflation is very low in AEs, whereas money printing after price liberalization in post-command economies created high inflation (after years of suppressed inflation and considerable money balances). This is due to an overwhelming liquidity trap and low inflation expectations.

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Unwoking corporate culture

Robert Oulds & Niall McCrae are the authors of Moralitis, A Cultural Virus

There's a right way and a wrong way for businesses to respond to survive the woke onslaught. Recently the British supermarket chain Co-op blundered into an unnecessary spat with the *Spectator* magazine, after a single person complained to the former for advertising in the latter.

Andrew Neil, chairman of Britain's biggest-selling current affairs periodical, showed how to turn the tables on a puritanical culture to which many other companies pathetically acquiesce.

A Co-op customer 'Lisa Fajita' had tweeted:

> *Hey @coopuk as a trans person I was please [sic] to see your adverts featuring a trans women and celebrating diversity, I visited your stores as a result, but why bother if your [sic] going to turn around ignore your members wishes and place adverts and fund transphobia in the spectator.*

A message opening with 'Hey' should immediately alert a company to a woke inquisitor. The complaint was spurred by a statement by Stop Funding Hate, a campaign against media perceived as right-wing (and thus purveyors of hate).

> *Many will be disappointed to see Co-op UK's management supporting a magazine notorious for transphobia and anti-Muslim propaganda.*

The Co-op social media team responded by promising to launch an investigation into its advertising policy, explaining:

> *This advert was placed as part of a package by our media buyers. We are taking up the issue with them with a view to them not using this publication again in the future.*

This submissiveness masquerading as ethics was brought to the attention of Andrew Neil, who immediately banned the Co-op Group from advertising in the magazine.

> *No need to bother, Co-op. As of today you are henceforth banned from advertising in The Spectator, in perpetuity. We will not have companies like yours use their financial might to try to influence our editorial content, which is entirely a matter for the editor.*

Sadly, the *Spectator's* robust stance against cancel culture is a rarity. A few days later the ecological protest organisation Extinction Rebellion blockaded national newspaper distribution centres around Britain, depriving millions of their morning read.

This act was blasted by politicians as an assault on free speech, but newspaper editors and journalists seemed apologetic, typically pleading that they had regularly publish reports on the climate crisis. This was the wrong response. They should have learned from Andrew Neil: no third party, individually or collectively, should be allowed to dictate content in the free press.

Clearly newspapers have been cowed by the assertive and articulate campaigning of Extinction Rebellion, as they were towards the agitators of Black Lives Matter. For years they have issued uncritical coverage of climate change alarmism, with any sceptics banished. James Delingpole, a trenchant critic of environmental doom-mongering, warned in his book *Watermelons* (2011) of the Marxist red in a green skin that threatens to destroy the economy and our children's future. No longer invited to write in the *Daily Telegraph*, Delingpole saw newspapers reaping what they had sown.

> *Far from underreporting the 'climate & ecological emergency', Britain's craven print media has stoked this #fakenews crisis by continually running, almost verbatim, press releases handed to them by eco-fascist organisations like Greenpeace and Fiends of the Earth, as well as by bloated rent-seekers on the environmental gravy train such as the wind industry.*

According to Delingpole, newspaper editors are running scared of vexatious legal claims, and of losing the sponsorship of green lobbyists: 'pretty much the entirety of the British print media is now bought and paid for by the Green Blob'. The more that companies allow undue influence in their enterprise, the more they become trapped.

Costly mistakes are being made by big brands that misjudge their market, giving too much licence to the youthful advertising industry to present their product in a progressive light.

In 2019 razor producer Gillette undid decades of brand building that celebrated its core market with the aspirational slogan 'the best a man can get'. Amidst the highly influential #MeToo campaign against sexual harassment, Gillette forsook positive male messaging to hector on 'toxic masculinity'.

As if giving a gender studies lecture, its new advertisements urged men to be more 'accountable' and to stop excusing bullying, sexual harassment and aggressive behaviour. They should learn to be a 'modern man', according to trendy young designers at the agency.

Knowing that this was provocative, Gillette must have expected that bad publicity would be outweighed by liberal plaudits on social media. Instead, it was the alienating misandry of the adverts that proved to be toxic. Following

"When social justice warriors want to 'start the conversation' it's time to walk away"

a backlash and calls for a boycott, the owner of the Gillette brand, Procter & Gamble, had $8 billion of its value wiped off.

However, Gillette CEO Gary Coombe was unrepentant: promoting a negative stereotype of men as predatory brutes demonstrated the brand's progressive virtue. Yet the feminising of men would neither succeed commercially, nor culturally. Many men responded to this insult by growing a beard.

Increasingly commercial organisations strive to project values, often of little relevance to their product. The ice cream brand Ben & Jerry's decided to publicly criticise the British government's policy on immigration.

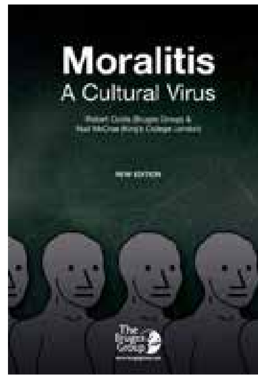
Thousands of migrants who had made their way to the north coast of France from the Middle East and Africa are illegally entering the UK by crossing the English Channel in dinghies. They are sent to large hotels around the country, these being mostly empty due to the coronavirus pandemic. Home Secretary Priti Patel promised action, but she seemed helpless to deport the incomers due to human rights law.

Ben & Jerry's tweeted: 'Hey Priti Patel' (that onerous greeting again) with a thread of Marxist claptrap about refugees, ending 'and lastly, for those at the back of the class, people cannot be illegal'.

This left a sour taste. Not only did it alienate British customers who think that laws should be obeyed and that economic

migrants shouldn't simply be allowed to break into an already overcrowded country, but it also gave the media an opportunity to highlight Ben & Jerry's faults, particularly their exploitation of cheap migrant labour.

The tax affairs of its parent company, the Unilever conglomerate, received unfavourable scrutiny. Before a company takes the moral high ground and self-righteously criticises others, it should first check for any skeletons in the cupboard.



As Ben & Jerry's sales slumped their tubs of ice cream were heavily discounted - a bargain for buyers who could stomach Ben & Jerry's hypocrisy. Ultimately, this foolish act of virtue signalling benefited their competitors.

A worrying trend is for businesses to exert influence on elections. Tyre maker Goodyear banned wearing of caps with the slogan 'Make America Great Again' in its workforce. This was the key message of Donald Trump's presidency campaign in 2016, and was well received in the 'Rustbelt' states where millions of jobs have been lost to the forces of globalisation.

Goodyear, a company that is integral to the US automotive industry, seemed to suggest that making America great again was wrong, perhaps too nationalistic, and that it was more important to distance itself from Trump than celebrate the industrial revival.

This petty action insulted not only employees but also the vast market of customers who voted for Trump. From a 'Main Street' perspective, Goodyear's political bias and censorship is reminiscent of the arrogant and out-of-touch elite that caused them to switch their support from the Democrats to the Republican Party. Indeed, the President called for a boycott of this now politicised product. Goodyear's share price instantly fell by 6%.

Dabbling in woke culture is a risky venture. Many companies have stepped into the minefield of gender politics, to their cost. When moviemakers and video-gaming franchises succumbed to feminist pressure to cast more women leads in heroic action roles, the result was box office duds and an exodus of disgruntled gamers.

Films with female leads were remade and defeminised for a woke audience, but Charlie's Angels flopped, as did the all-female remake of Ghostbusters. To deny that boys are drawn to action and girls to relationships and romance is to put political correctness before profit.

When the Always tampon brand removed the female symbol from its packaging to appease the transgender lobby, explaining that 'some men have periods too', a mixture of outrage and ridicule ensued. The TED talks franchise changed the title of its female-focused event with this tweet:

> *Hello you! TedxLondon-Womxn is coming back! That's not a typo: 'womxn' is a spelling of 'women' that's more inclusive and progressive. The term sheds light on the prejudice, discrimination and institutional barriers womxn have faced, and explicitly include non-cisgender women.*

This tweet was savaged on Twitter. India Willoughby, a transgender broadcaster, responded with derision: 'these people are nutters'. Transgender activists argue that trans women are women, based on self-identity, but the concept of 'womxn' creates a new category of sex. Perhaps this will become the accepted norm in progressive ideology, but there is only so far that the ordinary people can be pushed.

A few brave business leaders have taken a stand against woke zealots. The energy drink company Red Bull fired two of its North American executives, Stefan Kozak and Amy Taylor, after they promoted the Black Lives Matter movement. Around three hundred employees had signed a petition opposing the company's reluctance to openly support towards Black Lives Matter.

Austrian billionaire Dietrich Mateschitz, who co-founded Red Bull and owns 49% of the company, saw differently. As Red Bull quenches the thirst of all ethnicities, why favour one race over others? Indeed, why would a company risk upsetting customers by allying with a neo-Marxist movement that is wreaking destruction in American cities and calls to abolish police?

'Go woke, go broke' is a warning that company executives should heed. Fashionable causes change rapidly and are almost always in conflict with the socially conservative attitudes of the majority of the population.

Furthermore, woke ideology is becoming more extreme. In our book *Moralitis, A Cultural Virus*[1], we conceptualised this flight from reason as a social contagion, spread by memes rather than microbes. Social media facilitate this puritanical invasion of minds, causing a form of mass hysteria.

Having lost or failed to develop their powers of critical reasoning, younger people learn to spout absurd ideas that are ultimately to their detriment, such as internalising of shame for their sex or colour.

The Black Lives Matter campaign called for shaming of white people, using work-base training in 'unconscious bias', micro-aggressions' and 'white privilege'.

Thankfully, Donald Trump saw the damage this is causing and banned such divisive and 'unAmerican' training in federal agencies. The growing industry of 'diversity and equality' advisors have suffered their first defeat. More must follow. When social justice warriors want to 'start the conversation' it's time to walk away. ■

Endnote

1. https://amzn.to/3h8M56V

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COVID-19 has affected trade massively. Graham Bright says technology can boost the recovery

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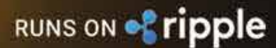

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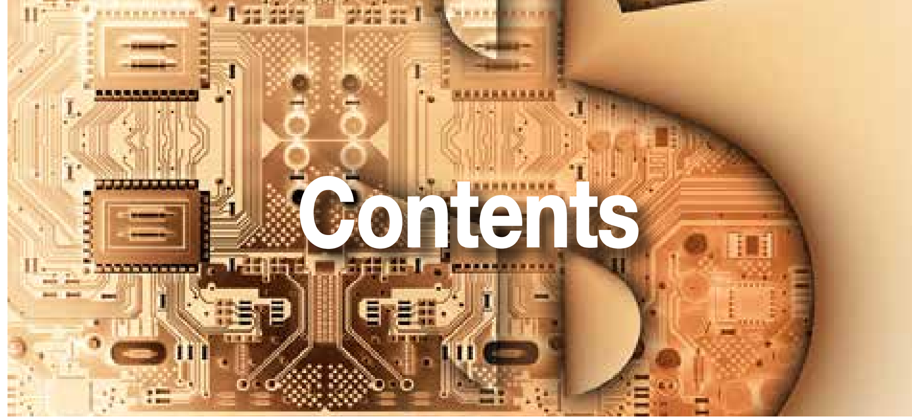

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Using technology for trade

Graham Bright is the Head of Compliance and Operations at Euro Exim Bank

Over the past 8 months, we have become all too aware of the effects of COVID-19 with continued clouds of recession, unprecedented economic disruption, excessive levels of debt and threats to basic normality of private and public life, employment and wealth creation.

Despite the gloom, trade is essential to every economy and must continue, even if volumes are expected to temporarily fall by between 13% and 32% in 2020. This reduction is not exactly a surprise, principally due to long standing trade tensions between the US and China affecting general economic slowdown.

Today, the rebuilding of supply chains, and getting trade re-energised with effective and cost-competitive flow of goods may only be work through international co-operation.

Whilst a number of free trade agreements are in place, there should be confidence in the supply and movement of ethically sourced, fit for purpose goods, without sanction.

However, the continued threat of trade barriers, isolationism and a constantly changing superpower stance on tariffs could seriously derail the efforts of emerging countries and all those fighting to protect their citizens and industries from economic wellbeing and future sustainability.

Competing nations need to put aggressive competitiveness on hold at least in the short term, as industries switch to production of health-related PPE. Buyers have radically changed buying habits, with home workers more concerned about food delivery than the latest fashion.

The travel industry, in particular air transport has been hard hit. With the Government forced into daily updates, u-turns and draconian health measures 'following scientific advice' regarding safe air corridors, isolating on return, lockdowns and fear have reduced passenger numbers at Heathrow by 88%.

Some airlines are withdrawing completely from strategic sites and regional hubs. With less planes comes less cargo space, with the price of air cargo and hence delivery of cost-effective goods rising on some routes up to 60%, especially affecting demand and availability of health-related items.

Marine traffic, the other lifeblood of trade has also been heavily impacted. Rather than free movement of goods, additional measures such as quarantine and closures have added significant documentation requirements. Containers and ships are in the wrong place, staff to handle them are on furlough, or required to wear expensive protection with new health measures, all adding cost and time.

Expensive goods are languishing at warehouses, with no demand, taking up expensive storage space. And lockdowns and social distancing have severely restricted the effectiveness of those inspecting and certifying goods to those checking the seaworthiness of vessels.

Massive cruise ships are at a standstill, empty, dormant dead assets, with only the prospect of a return to safe activity in 2021. What is clear is that joint coordinated activity, collaboratively between government and private enterprise, assisting importers with reduced tariffs and helping exporters through the minefield of trade documents and process to underpin a return to previous operating levels.

And now is the perfect time to push aside isolationism, nationalism, protectionism, tariffs and tax barriers.

With this background, how are technology and innovation going to resolve the issues of re-establishing confidence, maintain supply flows, ease any export restrictions and serve customers without vested interests? Can blockchain and AI enabled solutions satisfy the immediate and long term demands of the industry.

Let us immediately dispel the myth that technology and innovation are the universal panacea. Technology for technology sake will not miraculously re-energise the trade industry, boost confidence, bring back footfall to the failing retail sector and spark an international trade boom.

However, there are specific sectors where technology and innovation can make a significant difference. With such diversity, the first challenge to which technology is suited is in combatting fraud.

Unlike the world of payments, with standard information of payer, payee, bank account numbers, credit or debit and amount, the ecosystem of international commerce covers

a complex, expansive, non-standard group of companies, activities, legalities and challenges.

Losses due to fraud in the trade sector are projected to exceed $3.5 trillion each year, and, as criminals exploit and develop more inventive methods, companies are spending more to ensure they can quickly and effectively identify manage and mitigate risks. And yet recent press reports stated that compliance will be reduces in the coming year buy up to 25% due to cost and overhead.

Trade fraud is sophisticated, well planned and with heavy financial consequences, but in no way a new phenomenon. Records show trade fraud as far back as 300 BC, when a fatal bid to sink a barge of corn and claim insurance failed. Since then a litany of inventive schemes have become enshrined in history with the latest scams being COVID-19 antibody testing, and more alarmingly substandard, or non-delivered masks and medical supplies.

Domestically, COVID-19 has seen individuals working remotely spending time online, and more cases reported of phishing, credit card scams, online shopping fraud, investment scams, counterfeit goods, and identity theft.

The pace of fraud continues unabated with fraudsters using even greater sophistication, data breaches, duplicate invoices, card and identity theft involving hundreds of millions of customers. Despite all assertions to the contrary, it is not a case of 'if' security will be breached, but when.

A recent Hong Kong case saw the illegal simultaneous sale of the same non-existent goods to different international parties, backed by forged documents. The buyers, supported by experienced commodity banks, and following formidable due diligence, were duped. It appears that no matter how many checks are done, fraud can still take place.

This time, four major banks and creditors were out of pocket to the tune of $3.5 billion, leaving a trail of recrimination, huge financial loss and loss of confidence in future business.

The immediate impact is that banks are even more cautious to support new projects, revising their investment and support criteria. Through this bad experience, additional pressure has been placed on financing and support of smaller companies, now financially disadvantaged and left uncompetitive.

But whilst banks have been hit financially in this case, they are not immune from reproach for their own poor performance and in some cases criminal behaviour. The UK markets watchdog, the Financial Conduct Authority levied £4.3 billion in penalties for industry misconduct such as the Libor scandal (2.5 billion), with the US authorities fining banks over $75 billion.

Recently touted technologies such as blockchain and artificial intelligence technologies are well suited to be employed as part of KYC, openness, speedy implementation exchange, risk reduction and transparency, as key components in systems and processes fighting cybercrime and fraud.

"Confidence... is the key to a return to a new normal. More people are venturing out, high-street activity is increasing, although the demand for previous luxury goods and services will be different"

Would these have stopped the Hong Kong case? For example, would technology have saved the investors from misplacing trust in Madoff or Ponzi cases in what investors perceived as stable, sustainable, trusted schemes? And would they have provided early warnings of misrepresentation, alerted the regulators and mitigated the risks?

Probably not, as intent and means to pay, especially when large sums are involved, are not always guaranteed. Technology may have assisted in communicating immutable documents speedily, transparently and economically to all parties, but not immediately identifying possibility of criminal activity. The value of technology comes in providing a common base for example in timelines, audit trail and supporting evidence for forthcoming legal proceedings.

Implementing the technology

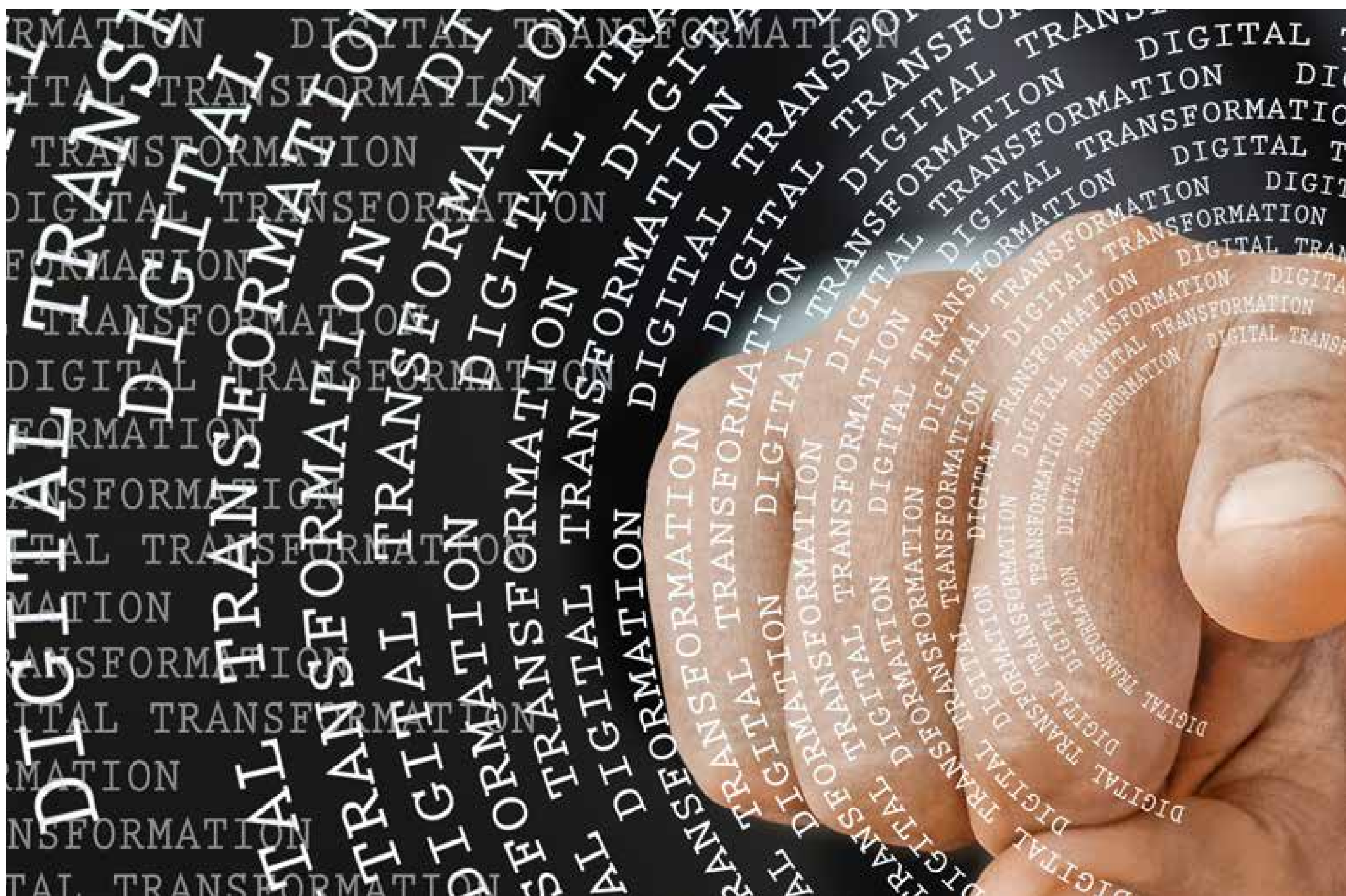
Recognised for our international awards and technology capabilities, our institution has always looked at use and integration of automated exception processes and how they may be enhanced, easily maintained and kept relevant.

We took early steps implementing blockchain capabilities inside our trade platform with a standard Hyperledger approach, leading to participation with Ripple with their secure, frictionless distributed ledger capabilities with xCurrent, to their inspired On-Demand Liquidity services. This uses XRP digital assets rather than costly fiat currency in the exchange process between local currencies.

The complexity of the ecosystem, the parties involved and differentiation of automation levels (ie. between shippers, banks, insurers, inspection agencies etc) have meant us investing in document digitalisation, which provides the solid foundation for information exchange with speed, standardisation, re-useability and rationalisation.

The challenge of implementing this type of technology in the worlds' importers and exporters in immense. Globally, there are almost 150 million micro, small and medium businesses, where small and medium sized enterprises accounted for 99% of the number of importing enterprises and 98% of exporting enterprises. One can only speculate at the level of automation and readiness in these firms.

With this market perspective, care and investment is imperative in delivering the right service, in accord with



compliance, due diligence, governance, regulatory adherence, treating customers fairly, sanctions, PEP lists, FATF and with knowledge of ever changing legislation such as International Emergency Economic Powers Act (IEEPA) and the Trading with the Enemy Act (TWEA).

In our day-to-day operations our growing sales teams in over 24 countries are armed with real-time systems in their quest for new business, liaising with companies anxious to control cashflow through appropriate collateral to trade competitively and efficiently cross border.

We continue to be surprised at the diversity, volumes and types of goods we see today, with evidence of US Dollars being used less in international trade as nations find alternative financial instruments to conclude their trades due to availability and cost of using the currency. First out of the blocks come Russia and China, actively reducing their dependency of dollars for bilateral trades, and opting for euro and local currency.

Euro Exim Bank are well ahead in systems innovation with our blockchain and AI integration and usage, but there is another technology making a profound impact on manufacturing, bringing economies of scale, innovation, low cost and almost unlimited potential across the globe, namely 3D printing.

The technology is already nearly 40 years old, but its commercial large-scale availability and reduced costs now make it exciting, multifunctional and economically viable.

For emerging markets, complete factories might be constructed on-site this way, with no imported or complex building process to navigate, and no heavy carbon emissions associated with use of concrete.

And, creating and supplying new product of almost any size may be as easy as receiving an email with a computerised design, uploading to a large-scale machine, and there are the goods, locally produced and managed.

By radically changing the source and content of goods, the cost model for effective international trade using cheap, affordable, sustainable 3D printed housing could be a game changer for emerging markets to increase wealth and wellbeing.

Using technology for trade

By re-engineering business processes through document digitising, improvements in ecosystem interoperability, faster goods certifications and linked insurance, quicker customs clearance without human intervention, less delay in ports,

technology would be providing a helping hand to kick start to remove inherent inefficiencies and ease flow of goods again.

Key technology already in place in our institution is enabling connectivity of all parties, with integration of e-contracts, electronic signatures on application and indemnity forms, and use of electronic payments. This is especially of value as we operate across multiple territories, enabling client anywhere to correspond and settle electronically throughout the lifecycle of the transaction.

Confidence

This is the key to a return to a new normal. More people are venturing out, high-street activity is increasing, although the demand for previous luxury goods and services will be different.

Many countries are analysing their supply chains, looking at points of origin, costs of transport, and bottom-line costs to do business. India, for example, are looking at more domestic providers, rebuilding the economy with home manufactured goods rather than the time-honoured reliance on China.

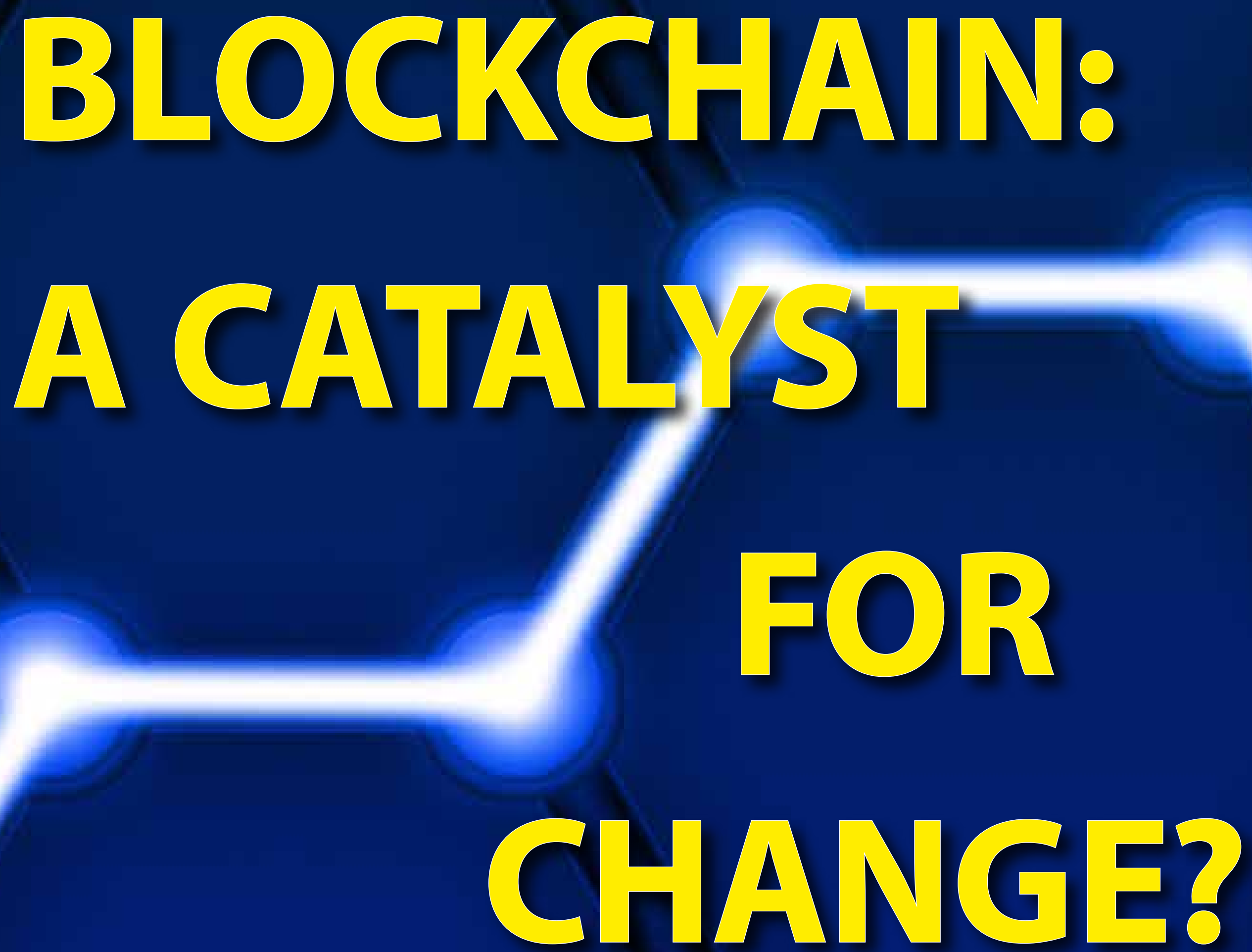
And this trend is being repeated across Africa and Europe. Britain is also looking to rebuild manufacturing and tourism and look at specialist service industries keeping income within national boundaries.

Conclusion

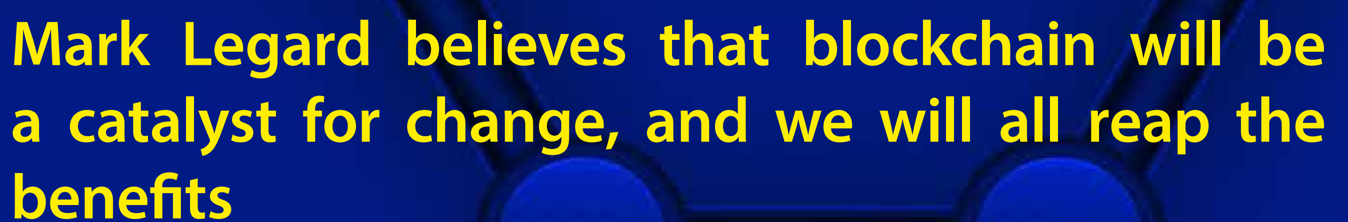
International trade has been going since pre-historic times and often it feels like nothing has changed. But in the past few years, communications have dramatically enhanced, with mature supply chains and emerging market opportunities, and electronic means to exchange value.

Despite recent shortcomings of fraud, cybercrime and instrument complexity, and of course the uncertainty and dramatic economic effects of pandemics, we firmly believe that trade will continue and flourish, and we stand ready to support all initiatives and participants in its continuance.

Technology, especially with blockchain, has not yet reached the extent of its possible application. Document digitalisation will be the first major milestone and once all players across the entire global ecosystem are fully apprised, ready and able to use the technology, it has the benefit and capability to reduce the inefficiencies, inaccuracies, time and level of proprietary information requiring human intervention and cost so prevalent in trade today. ■



BLOCKCHAIN: A CATALYST FOR CHANGE?



Mark Legard believes that blockchain will be a catalyst for change, and we will all reap the benefits

The blockchain principle was initially proposed in 1991, where it uses a distributed database that autonomously maintains a continuously growing list of public transaction records in units of 'blocks', secured from tampering by time-stamping and encrypted hash links. Blockchain was developed further in 2009 when Satoshi Nakamoto proposed the cryptocurrency Bitcoin. This has led many to associate blockchain with Bitcoin.

However, the potential use of blockchain goes well beyond the world of cryptocurrencies. For some, it is a revolutionary technology that will change our lives, while for others it is a mere pipe dream. No technology has stirred up so much debate since the advent of the internet. However, despite the numerous headlines on blockchain, the technology remains difficult to comprehend for many.

At its core, the blockchain is a technology that permanently records transactions in a way that cannot be later erased but can only be sequentially updated, in essence keeping a never-ending historical trail. Blockchains also enable assets and value to be exchanged, providing a new, speedy rail for moving value of all kinds without unnecessary intermediaries.

A brief explanation of how blockchain works is needed. For blockchain to work a distributed ledger is required. Each block in a chain contains data, a hash of the block (a hash can be compared to a fingerprint, and is always unique), and a hash of a previous block.
The hash of a previous block creates the chain and makes the blockchain secure. If a block is changed all the other blocks are invalid. With todays computer power it is possible to change a block, and all hashes.

Therefore, a proof-of-work mechanism is used to slow down tampering. Blockchains also use a distributed P2P network, where all members of the network have a copy of the blockchain.

When a block is changed all members receive the change. This creates a consensus where all members agree on which blocks are valid. Tampered blocks will be rejected by other nodes (members) in the network.

So, to successfully tamper with a blockchain you will need to alter all blocks on the network, redo proof-of-work, and control more than 50% of the P2P network. Only then will your tampered block be accepted by everyone else. This is almost impossible to do.

There are various ways to categorise blockchains. There are public (no specific entity manages the platform), private (the platform is controlled by a single entity), or managed (by a consortium of companies) blockchains.

Another category that is sometimes used is permissionless (the blockchain is open to everyone – for example Bitcoin) or permissioned (restrictions can access the blockchain).

In practice there are many variants of blockchains depending on the objectives being sought. Many applications in the field of international trade fall into the category of permissioned/consortium blockchains. One thing to note is that though blockchain is only one type of distributed ledger technology the term is now often used to refer to distributed ledger technologies in general.

This seemingly simple functional description has massive implications. It is making us rethink the old ways of creating transactions, storing data, and moving assets, and that is only the beginning. In the trade arena possible applications of blockchain encompass a diverse set of areas including trade finance, customs and certification processes, transportation and logistics, insurance, distribution, intellectual property and government procurement.

Multiple consortia have been formed, comprising mixes of large-scale corporations and start-ups, to explore common open source blockchain technology solutions for particular industries. The biggest banks formed a group called R3CEV, for example, before expanding to a membership of greater than 100 that included many non-banks.

Hyperledger, which has been building private enterprise solutions, is similarly large and includes big players such as IBM, Cisco and Intel. Meanwhile, blockchain consortia have also been formed for the music, advertising, energy, Internet of Things (IoT), real estate and various other industries.

Government agencies, non-government organisations and international development agencies are also now exploring multiple use cases aimed at enhancing official information, streamlining government-citizen relationships and boosting financial inclusion.

The applications of blockchain technology and smart contracts are broad. Many have gone beyond merely proofs of concept. Blockchain-based peer-to-peer payments are the best-known examples. Bitcoins, Lightning, Ripples, LITEX, and others make value transfers on decentralised networks possible, without relying on trusted third parties.

Trade finance, an industry with a $10 trillion annual volume, in particular is suitable for blockchain applications. Large institutional players or consortiums such as Barclays, IBM, Walmart, and R3 CEV have all developed their own trade finance blockchains. The first global trade transaction, shipping butter and cheese between Ornua and Seychelles, was completed in 2016.

In general, blockchains interact with dispersed record keepers to reach a decentralised consensus. Similar to third party arbitrators or witnesses in the traditional economy, they receive signals on the true state of the world, and may have incentives to tamper with those signals, or manipulate them.

With the help of fast-developing real-time communication technologies, blockchains can mitigate individual misreporting incentives, allowing for better information aggregation and more efficient contracting. Nevertheless, to generate a more effective consensus, decentralised record-keepers need to be able to observe and receive greater amounts of information.

Consequently, blockchain applications feature a fundamental tension between decentralised consensus and information distribution. The impact on welfare and consumer surplus can be ambiguous.

One needs to ask what are the benefits of blockchain in global trade? International trade is a $16 trillion market that accounts for the exchange of capital, goods, and services across international borders or territories.

It is broadly split into two categories: a variety of goods, typically shipped by shipping containers or ground transportation, and commodities.

From a shipping and transportation viewpoint the trade and financing industry primarily suffers from a lack of trust and coordination between exporters and importers, particularly within emerging to developed markets.

Additionally, the industry maintains various operational inefficiencies due to the complex nature of operational processes in the international trade of goods and commodities.

For instance, shipping and trading still heavily rely on human resources and are affected by manual and paper-based processes which are very costly, slow and error-prone.

Exporters and importers face challenges to finance or guarantee their transactions, which stymies growth and limits the benefits from globalisation.

Over the past decade or so many start-ups and technology companies have attempted to develop products with mixed success— until the emergence of blockchain technology for which international trade is identified as a primary use case.

The potential impact of blockchain technology on international trade finance has spurred many companies and consortiums to update their outdated technology. Beyond ushering in the era of digitisation, blockchain enables the tokenisation of existing documents, letters of credit, and more.

Smart contracts will improve coordination between exporters and importers through the automation of agreements, business events, and other manually intensive processes. The global adoption of blockchain technology will create even greater benefits for cross-border coordination, trade settlement, and standardisation.

Commodities trading represents a quarter of international trade and is comprised of energy, base and industrial metals, agriculture and soft commodities.

More than half of commodities trading is financed by banks and other financial institutions or funds. Software and new technologies have emerged to serve this industry over the past two decades with varied successes.

But like the international trade of container goods, commodities markets remain affected by operational inefficiencies and costs including:

"... blockchain technology presents an opportunity to fundamentally transform the way financial markets work"

- Fraud: the widespread use of paper documents increases opportunities for malicious behaviour (double financing, etc.).

- Delays: it takes 90-120 days to book the shipping of a commodity, request trade financing, collect documents, provision the documents to buyers, and facilitate payments.

- Loss of income and opportunity: these fractured processes and high operational costs hinder innovation for the entire industry and cause billions of dollars worth of annual losses in income and opportunity.

Blockchain technology can reduce fraud through a distributed and immutable ledger where information cannot be manipulated without notifying all parties involved. The entire history of transactions is easily accessible utilising the inherent properties of distributed ledger technology.

Additionally, blockchains native ability to create and transfer digital assets enhances various existing commodities trading processes outlined above. The real-time data and transactions enabled by smart contracts has the potential to reduce delays and automate manual processes.

The inefficiencies throughout the commodities trade industry result in a loss of income and opportunities for businesses. As blockchain technology grows in adoption, it will help firms, investors, and the other parties involved in commodities trading realise greater gains and increased profitability.

Based on estimates from $4.4 trillion commodities markets, approximately 30% of the benefit from trade financing is claimed by banks, financial institutions, institutional investors, or funds.

For example, the Asian Development Bank highlighted the potential for growth of the global trade finance market by identifying a $1.6 trillion gap between supply and demand for trade finance, particularly for trade flows to and from emerging markets. This gap stems from know-your-customer (KYC) and compliance issues as well as poor profitability due to labour-intensive costs (operational, KYC, due diligence).

Blockchain technology can be implemented to overcome the various issues that occur throughout the KYC and regulatory compliance process. The historical record and transparent ledger provided by blockchain networks provide near real-time monitoring of transactions for multiple parties involved.

Regulatory agencies can gain access to permissioned blockchain consortiums improving anti-money laundering

or auditing. Finally, blockchain has the potential to facilitate greater access to trade finance on both the supply (alternative investors) and demand side (SMEs from emerging markets).

Blockchain could have a significant impact on business processes and supply chain management. Blockchain can digitise, secure, streamline, and ultimately accelerate operational processes and supply chains across global markets.

Transactions in international trade can take up to four months to complete. Moving away from paper-based processes towards digitally verifiable and legally enforceable documentation means more rapid industry operations and the reduction of fraud.

For gas and power, where problems center around reliable data sharing— blockchain will enable information alignment, quicker imbalance resolution and settlement processes, and also more efficient delivery practices.

For renewable energy, where problems centre around reliable reporting of industrial carbon emissions or energy produced through renewable assets — blockchain offers increased trust through network transparency and governance systems that connect all stakeholders.

The movement of huge volumes of basic materials that are needed to fuel and feed the world is complex. It requires multiple counterparties that lack effective coordination because many producers are found in remote locations and emerging economies. As markets become more efficient, commodity trading is evolving into a low-margin service business.

Increasingly, traders make their living by providing a solidly reliable logistics service between producers and consumers. These facets inherently raise the risk of transactions, contributing to the limited access for new or growing companies. Blockchain's cost-reducing capabilities will increase margins while its deterministic trust structure will drive accessibility within the market.

Blockchain will impact trade finance. As an extension of international trade, trade finance undergoes the same cumbersome operations processes. Most rejections of trade finance requests submitted by SMEs in emerging markets to financial institutions stem from compliance problems, lack of trust, and low profitability.

Blockchain solves many of these issues by authenticating documentation, streamlining operational processes, and facilitating coordination between multiple stakeholders. In addition, blockchain simplifies access to alternative investors through marketplaces, thereby increasing sources of funds for smaller players.

What happens when a trade is completed? Current practices around trading are commonly viewed as inefficient for having too many intermediaries involved (security trade brokers, custodians, and payment agents), for being prone to settlement risks, and for having settlement cycles that are unpredictable and time-consuming.

Blockchain technology has the potential to dramatically simplify the chain of post-trade operations, guaranteeing and facilitating the consolidation of securities registers, all while enabling a higher speed of execution, reducing transaction costs, and enabling real-time settlement.

Across supply chain management, commodities logistics, and post-trade settlement there is significant long-term potential to develop trade and finance-focused marketplaces in order to simplify access for both supply and demand parties, increase liquidity, stimulate competition, and heighten efficiency.

Blockchain technology offers greater transparency and a single source of truth for participants using supply chain networks. Intelligent track and trace of orders, goods, and delays via blockchain could expedite the sending and receipt of goods. In particular, blockchain provides the following benefits:

- Digitisation. Most non-integrated supply chains still rely on insecure and inefficient physical processes. By using blockchain, stakeholders digitise physical processes with smart contracts to address these issues and enhance productivity.

- Authenticity. Producers, manufactures, retailers and customers all face difficulties in verifying product' authenticity. This boosts counterfeiting. With blockchain, products may be linked with non-fungible tokens at the moment of creation. These tokens may then be used as digital certificates. A non-fungible token is a special type of cryptographic token which represents something unique; non-fungible tokens are thus not mutually interchangeable by their individual specification.

  NFTs are used to create verifiable digital scarcity, as well as digital ownership, and the possibility of asset interoperability across multiple platforms. NFTs are used in several specific applications that require unique digital items like crypto art (rare art), crypto-collectibles and crypto-gaming.

- Distribution control. Most brands and retailers cannot control distribution outside of their own channels. With blockchain, they can use smart contracts to define specific rules to manage distribution across multiple channels.

- Post-sale services. Many retailers are not able to provide comprehensive after-sales services— including recall, warranties, and maintenance— because they lack information about a product's provenance.

  With blockchain, they can use product life-cycle information secured in smart contracts to develop additional after sales services.

- Transparency. Customers expect to have transparent information about products' raw materials and manufacturing processes. With blockchain each stakeholder across the supply chain can provide verified information.

- Verified ownership. Customers face difficulties in proving product ownership. This boosts theft and counterfeiting. With blockchain, customers can collect and manage NFTs, associated with physical products, and use these tokens to prove product authenticity and ownership, enabling safe secondary markets.

Despite its infancy, blockchain technology presents an opportunity to fundamentally transform the way financial markets work.

The challenge is to reduce the cost of trust, to protect against criminal interference – money laundering and terrorism, for instance – to ensure that the technology is appropriately adopted, utilised and governed.

When and if these problems are solved, blockchains could provide enormous economic, social, and political benefits to society.

While the technology opens interesting opportunities to enhance the efficiency of a number of processes and cut costs in these areas, it is not a panacea. Carefully weighing the costs and benefits is essential.

Nevertheless, blockchain will be a catalyst for change, and the public, blockchain technology and the financial system will all reap the benefits, sooner rather than later if the stakeholders take advantage of the opportunities that blockchain offers. ■

Reinventing the wheel (with more automation)

Andrew Bailey is Governor of the Bank of England

Introduction

Even central bankers can sometimes be accused of overusing language. So, the world is always more uncertain than ever – except that at the moment it really is. And, innovation is all around us except in the productivity numbers. One area where innovation really is around is the world of payments, the focus of this article.

Innovation is a good thing. As authorities and regulators it is not in our interest – the broad public interest – to stop innovation. Moreover, when supported by clear standards and expectations, innovation can support the pursuit of public interest objectives such as greater inclusivity and network resilience. Making such standards clear early is much preferred to attempting to claw back the ground later, and particularly if that comes after things go wrong.

This is the backdrop to innovation in payments, particularly in the area of so-called digital currencies, developed to offer new forms of 'money'.

The way we pay for things is changing rapidly. As people increasingly turn away from transactional use of cash, which comes after the decline of cheques, innovative alternatives are flourishing. The focus of use of such innovation has so far more been within domestic markets. The picture of payments going across borders is less encouraging. It can still take as long as 10 days to transfer money to different jurisdictions and the transaction cost can sometimes be 10% of the value of the transfer[1].

As part of a global G20, Financial Stability Board (FSB), and Committee on Payments and Market Infrastructures (CPMI) initiative, the recent report on *Enhancing cross-border payments: building blocks of a global roadmap* clearly sets out the challenges and frictions that exist[2].

These include significant barriers to entry, long transaction chains with multiple currencies and intermediaries involved, legacy technology, limited operating hours, and high operating costs from compliance checks and funding requirements.

The CPMI Task Force on Cross Border Payments; involving the Bank of England, other central banks and standard setting bodies, has led this work, and has set out an ambitious plan for a joint public and private sector vision; global regulatory, supervisory and oversight coordination; improvement of existing payment infrastructures; enhancing data quality; and exploring the potential of new innovations.

But, with these benefits comes risks and challenges for authorities. We should treat this as being in the nature of change. The Bank of England's Financial Policy Committee has set out principles to respond to the significant changes in the payments landscape. Payments regulation should reflect the financial stability risk, rather than the legal or technological form, of payment activities.

Firms that are systemically important should be subject to standards of operational and financial resilience that reflect the risks they pose, with sufficient data available to monitor emerging risks. These may sound like common sense points, but innovation is increasingly challenging regulators' ability to ensure they are met.

Money and cash

Returning to the theme of central banks and their particular use of language, an important distinction we often refer to is between central bank and commercial bank money. Literally, this is the distinction between money which is a direct claim on the balance sheet of a central bank and money that is a claim on the balance sheet of an authorised and regulated commercial bank to which the local deposit protection rules apply.

Central bank money takes two forms. Reserve accounts are held by banks and other financial institutions and provide part of the stock of high quality liquid assets and from that the balances used to effect the making and settlement of payments between themselves. They are also a crucial part of how central banks set monetary policy. Cash is the only form of central bank money accessible by the general public.

Another important term to bring in here is fiat money. Fiat money is state-backed money denominated in the national currency. Cash is a form of fiat money. Commercial bank money is only acceptable for wide scale use in the UK if it is denominated in sterling, convertible into sterling fiat money at par, and convertible on demand.

Private providers of commercial money need to demonstrate they can meet these obligations so that individuals and

business can have confidence in being able to regard different types of money as indistinguishable from cash, and be able to change it 1-for-1 on demand.

Until recently in the UK, cash accounted for the largest number of payments (by number not value)[3]. But in the UK the use of cash in transactions was declining before the COVID pandemic. With the impact of COVID and the UK lockdown, cash withdrawal volumes have dropped further.

At their lowest during the UK lockdown, cash withdrawals were 60% lower in April 2020 than a year before. Even as the UK lockdown has eased, cash withdrawal volumes have remained low - in July they were around 40% lower than the year before[4]. The increased use of non-cash payments places even greater importance on payments systems, which underlies the work the Bank is doing to upgrade RTGS.

But, there is an increasing paradox in the area of cash. I can speak from personal experience on this as a former Chief Cashier of the Bank of England. When I became Chief Cashier at the start of 2004 the value of notes in circulation (NIC) was £34 billion. When I moved on in March 2011 it was £49 billion. Today it stands at £77 billion. It took 310 years to get to £34 billion and then just over 16 years to move on to £77 billion, and it has not fallen[5].

The paradox of cash is obvious: use in payments is declining but the value of the stock in issue is not. For the sake of brevity, I'm not going to discuss the possible explanations of the paradox here.

Meanwhile, innovation in payments picks up pace.

Traditionally, outside the use of cash, payments have been made in commercial bank money using systems that settle in central bank money across the reserve accounts held by banks. Central banks have increasingly brought these systems under regulatory oversight with the intention of ensuring appropriate legal finality of settlement and operational resilience.

More recently, innovation has started to strain at this framework in a number of ways. I will set out three forms that this innovation takes, and why it raises questions.

I will start with crypto-assets, such as Bitcoin, which have appeared in the last ten years or so. They have no connection at all to money. They may have extrinsic value – you may like to collect them for instance, and as such they are a highly risky investment opportunity. Their value can fluctuate quite wildly, unsurprisingly. They strike me as unsuited to the world of payments, where certainty of value matters.

The next innovation is alternative payments such as e-money, which in Europe has grown under the auspices of the Second Electronic Money Directive (EMD2) and the Second Payment Services Directive (PSD2).

To be clear, this has been translated into the UK as part of the on-shoring of EU law in the context of Brexit. This regime creates something which is more money-like in the sense of commercial bank money, but doesn't have the same direct link to fiat money, and the safeguarding regime does not have all the features of deposit protection. It is therefore a hybrid.

"We have reached the point in the cycle of innovation in payments where it is essential that we set the standards and thus the expectations for how innovation will take effect"

We must ensure that users fully understand the difference in protection, and I suspect at the moment that is not widely the case. The standards are less developed than those for banks, there is no depositor protection scheme, and firms are subject to only limited capital and liquidity requirements.

Finally, there is no resolution or administration regime. This means that if firm failed, holders of its 'money' would be forced to pursue any recovery through a corporate insolvency procedure, which would neither be quick nor guarantee their funds back.

The third innovation, and the one on which I will focus more, is so-called stablecoins.

Where many earlier forms of crypto-assets, such as Bitcoin, have proved unsuitable for widespread use in payments, stablecoins, and particularly global stablecoins, aim to do just that. Not all stablecoins are intended for use in making payments. Some stablecoin proposals may be used to facilitate investments.

However, where a stablecoin is used to facilitate the transfer of 'money' for buying goods and services and the settling of debts, then it may become widely used a means of payment and store of value.

Global stablecoins seek to apply new technology, stemming from the world of crypto-assets, as well as changing some of the fundamentals of the underlying payment chain. They change not only how you pay but what you pay with – rather than a transfer of money between bank accounts, stablecoin systems transfer the asset itself – the stablecoin – from one person to another.

Stablecoins could offer some useful benefits. For example, they could further reduce frictions in payments, by potentially increasing the speed and lowering the cost of payments (particularly if global stablecoins were to be established). Stablecoins may offer increased convenience, including via integration with other technology, such as social media platforms or retail services.

If stablecoins are to be widely used as a means of payment, they must have equivalent standards to those that are in place today for other forms of payment types and the forms of money transferred through them. This will ensure that they are safe and resilient and that consumers can use them with confidence.

To reiterate, a key principle for payments is that users can be confident that the instrument they use to transfer value can be converted into fiat money at any time. And, in the rare circumstances that the entity that issued that instrument fails, that there are clear rules and protections for the payment recipient and for the consumer.

It is this assurance that stabilises the value of the transfer asset so that all parties in the economy can rely on it. Banks achieve this by giving the customer a money claim at par, supported by banks' access to central bank facilities and extensive regulation of banks' activities, including a protection scheme for customer deposits up to a certain amount.

It is these protections that mean that individual shop owners don't worry about scrutinising which bank issued your debit card before you tap it to pay.

It is these protections that prevent a return to the literal Wild West in which individual banks issued their own private currencies, which were worth different amounts depending on recipient's assessment of the soundness of the issuing bank.

What is not acceptable is to fall between regimes – for instance to argue that by holding backing assets such as sovereign bonds that are in general much safer than those on a bank's balance sheet, this is good enough to ensure convertibility into fiat money at par. Low risk is not the same as no risk.

This is why the FPC set out in its *Financial Stability Report* that stablecoins used in systemic payment chains should meet the standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.

Some major stablecoin proposals do not appear at present to meet this expectation

Some stablecoin proposals do not include a legal claim for coin-holders. And some stablecoins propose backing in instruments that may have material market, credit and liquidity risk, but do not have the money protections I have outlined.

While this might be acceptable for speculative investment purposes, it would not be for payments widely relied upon by households and businesses. Stablecoins need to offer

coin-holders a robust claim, with supporting mechanisms and protections to ensure they can be redeemed at any time 1-to-1 into fiat currency.

Some may ask if this would rule out a multi-currency stablecoin? Such a proposition is the wrong place to start – it raises questions around the value of the coin, and the underlying money it represents. The starting point for a global stablecoin should be based on single currencies. We should not run before we can walk.

Setting standards early on

We must therefore set standards early on so that innovation can take place with confidence on what will be required. This gives certainty not only to regulators and users but also to innovators.

Indeed, the international community has agreed that *"no global stablecoin project should begin operation until the legal, regulatory and oversight challenges and risks… are adequately addressed, through appropriate designs and by adhering to regulation that is clear and proportionate to the risks."*[6]

However given the novel form, existing standards do not necessarily easily apply. There need to be minimum international standards for stablecoins. In addition any stablecoin with potential for wide scale use in the UK must meet our domestic expectations. A stablecoin which intends to launch with sterling-based activities in the UK should first meet relevant standards and be appropriately regulated.

And if a sterling retail stablecoin wishes to operate at scale in the UK, then we will strongly consider the need for an entity to be incorporated in the UK. This is similar to the subsidiarisation of banks that we require if they are holding UK retail transactional customer deposits above a de minimis level[7].

But a global stablecoin is a cross-border phenomenon. It can be operated in one jurisdiction, denominated in another's currency and used by consumers in a third. The regulatory response must match this.

As in banking and traditional payment systems, the regulatory response must be grounded in internationally-agreed standards. Global issues require a global response, particularly for multi-currency stablecoins intended for cross-border transactions.

Along with the G7, the Financial Stability Board has been leading co-ordination of the international response to global stablecoins. The FSB consulted in April on the regulatory and supervisory challenges they present, with a final report due in October, and the Bank of England supports the efforts to set

a baseline set of expectations. These include that stablecoins should be regulated based on the functions they perform and risks they create, and that there should be comprehensive domestic and international regulation and supervision.

Global stablecoins should have robust governance and risk management, and be transparent about their stability mechanisms and coin-holders' rights.

This baseline set of expectations will help avoid regulatory fragmentation and is an important and necessary step. But alone it is not sufficient. Existing standards must be examined and updated where necessary.

There needs to be a clear G20 mandate for the various sectoral standard-setting bodies to consider their standards and whether they need to be refreshed or clarified in light of stablecoins. This is necessary to truly deliver on the principle of same risk - same regulation.

The Committee on Payments and Market Infrastructure (CPMI) and International Organization of Securities Commissions (IOSCO) are working to ensure that it is clear to stablecoin developers how international standards of regulation and supervision for financial market infrastructures, including payment systems, (the Principles for Financial Market Infrastructures – PFMI) will apply to them, including where stablecoins are used in systemic payment systems.

Other standards setters, such as the Financial Action Task Force (FATF) and the Basel Committee on Banking Supervision (BCBS), will need to respond as well.

Coordination between regulators is essential too. In particular, host regulators of global stablecoins must, and are, working with other regulators in other jurisdictions to ensure that they are appropriately regulated and gaps in coverage, opportunities for regulatory arbitrage, do not emerge.

The Bank looks forward to the conclusions of the FSB's consultation, and the subsequent finalising of international work, to ensure a comprehensive framework can be in place.

Current proposed global stablecoin offerings will need to demonstrate how they meet these key domestic and international standards. They must do so before the global regulatory community can be comfortable with their launch and widespread adoption.

Central Bank Digital Currency

A very reasonable and important question is whether a better outcome would be for central banks themselves to harness much of the technological and IT systems innovation and directly digitise cash? A Central Bank Digital Currency (CBDC) would be an electronic form of central bank money that could be used by households and businesses to make payments.

Digital central bank money would surely address the decline in the use of paper money without the complications of creating the protections required around stablecoins? Yes and no is I suspect the answer. The question is a good one and should be considered (and is being so) but the answer is not in yet. It's a very big question.

Offering a CBDC would allow broad access to central bank money in a digital form. But any launch of a CBDC requires careful prior consideration to fully explore all the issues and implications in order to make an informed decision, including ascertaining that there would be demand for such a thing.

CBDC, whilst offering much potential, also raises profound questions about the shape of the financial system and the implications for monetary and financial stability and the role of the central bank. There are fundamental questions in play.

What might a CBDC mean for monetary policy transmission – would it bring new tools and fuller, faster transmission of policy choices? To what extent would a CBDC 'disintermediate' the banking sector, and what impact would this have on the cost and availability of credit, and the resilience of banking business models and funding?

And what services and infrastructure should a central bank offer as part of a CBDC and what might best be left to the private sector?

The paper from Brookings in July on *Design Choices for CBDC* helpfully explored a number of these issues, as well as key technological points on the need for interoperability and connectivity between and among central and commercial bank systems for CBDC to function effectively[8].

Such standards are even more important in a world where there might be a need for interoperability and friction-free movement between CBDC, private stablecoins and other payment mechanisms. We, along with international counterparts are considering these closely.

The Bank of England is exploring these issues and published its *Discussion Paper* on CBDC earlier this year[9], setting out key considerations and an illustrative model based on a central bank core ledger and private payment interface providers offering overlay services to users. The paper received a wide range of responses.

We are currently working through the responses, continuing to engage with stakeholders and look forward to setting out more information next year. We are also working closely with our international counterparts who are facing the same questions.

Stablecoins and CBDC are not necessarily mutually exclusive. Depending on design choices, they could sit alongside each other, either as distinct payment options, or with elements of the stablecoin ecosystem, such as wallets, providing consumers with access to a CBDC. So there will likely be a role for the private and public sector working together in the future of payments.

As well as not being exclusive, stablecoins and CBDC are not the only ways to meet changing demands and reducing frictions in payments. We need to continue to enhance existing

infrastructure, including by renewal and harmonisation of RTGS systems. This work will continue in parallel with other developments. There are also initiatives like the UK's New Payments Architecture, which offers a consolidated and open retail payment infrastructure.

Public policy questions raised by digital currencies

The rise of stablecoins and the emerging proposition of CBDCs pose fundamental questions about the role and responsibilities of private firms and central banks in the world of payments.

I have outlined the key role of authorities in ensuring the stability of money, through issuing and ensuring confidence in central bank money (from monetary policy through to making it hard to counterfeit), and regulating banks to ensure commercial bank money is stable and convertible on demand. Oversight of payment systems transferring this money ensures they are resilient and can be used with confidence.

But the changing nature of money causes us to pause and consider the importance and implications of money which extend much further than a simple exchange of value or financial transaction, and the policy implications are much greater than the specific mission of a central bank. In short, money has social, and not just financial functions.

Who should be responsible for the integrity and security of the digital payments architecture? Digital currencies will create not just a novel form of money, but also a new payment infrastructure, which while likely bringing benefits to payment efficiency, raises questions around transparency and how resilience and consumer protection will be ensured. Central banks might be involved in this infrastructure too, but where might the role of the central bank start, and stop?

Privacy and data protection issues are also a key question. Digital currencies, depending on their design, could provide considerable information on how people spend their money, and we cannot compromise on the protection of our privacy.

Private firms might seek to use these data, with appropriate user consent, to offer improved services, but we've seen widespread miss-use of data in the past. Digital payments could entail greater data on users' identities and transactions being centrally visible. The data generated could have huge opportunities for the detection and prevention of financial crime, but this must be balanced with the risk of surveillance into private financial matters.

These questions, as well as issues of encouraging inclusion and promoting competition, are not ones for central banks and regulators alone to answer. They go the heart of how we use money and who should be responsible for safety and security. There needs to be a wider debate between policy makers, governments and society as a whole.

Conclusion

We have reached the point in the cycle of innovation in payments where it is essential that we set the standards and thus the expectations for how innovation will take effect. It should not happen the other way round, with the standard setting playing catch up.

The answer is not to strangle innovation, and it does therefore require a strong dialogue between the parties, which I think we have. It also requires the sort of thoughtful input that Brookings scholars have made.

If I can end with one overarching point, I think the public expects its payments to carry the assurance of value that comes with money. At this point, my mother would have said firmly to me, *"Thank you for that statement of the blindingly obvious."* To which I would say, *"I look at the debate going on and it isn't so obvious anymore, but it should be."* ■

Endnotes

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Europe needs a fully fledged capital markets union - now more than ever

Luis de Guindos is Vice-President of the ECB, and Fabio Panetta and Isabel Schnabel are Members of the Executive Board of the ECB

The capital markets union (CMU) is one of the cornerstones of the euro area's financial architecture. But progress in developing it has been slow. Since the agreement on establishing CMU in 2015, many sub-projects have been launched, and some completed, but European capital markets are still far from being fully integrated.

Despite the fact that the coronavirus (COVID-19) crisis has made CMU more important than ever, progress has unfortunately slowed, notwithstanding the substantial headway made on the fiscal side with the agreement on the European recovery package (Next Generation EU).

Financing the post-crisis recovery is one of the most pressing challenges Europe is facing today. Capital markets will be crucial. The new bond issuance by the European Commission, in the context of Next Generation EU, relies on well-functioning capital markets[1].

But public funding cannot do the heavy lifting alone; it will have to be complemented by substantial private financing. With the banking sector under pressure due to the pandemic, private bond and equity markets can play an important role in complementing bank financing.

In order to recover from the pandemic and strengthen the euro area's growth potential, a new push is needed towards the long-term ambition of creating a genuine single European capital market that is deeply integrated and highly developed.

This will not only mobilise the resources needed to reboot the euro area economy after the global contraction. It will also help meet the additional challenges posed by external developments, such as Brexit and global trade tensions[2].

In addition, it will provide opportunities for accelerating the transition to a low-carbon economy – thereby supporting the European Union's ambition to be a leader in green finance – and for funding the transition towards the digital economy. A single capital market will also strengthen our common currency's role on the global stage.

And last but not least, a deeper and more integrated financial system is also needed from a monetary policy perspective, as integrated capital markets improve the transmission of our single monetary policy to all parts of the euro area. In turn, this will help limit the risk of growing asymmetries among member countries as our economies recover from the COVID-19 shock at different speeds.

Our aim with this blog post is to re-emphasise the importance of strengthening efforts to advance the CMU project, in the light of the European Commission's forthcoming new Action Plan[3]. First, we explain why CMU is important, especially due to the COVID-19 crisis.

Second, we describe the current state of play regarding capital market development and integration in the EU, and identify the areas where progress is needed most.

And third, we set out a roadmap of policy measures that would remove core barriers to further integration.

Following this roadmap would benefit the euro area, the EU and its citizens. It would stabilise funding sources for households, companies and governments, foster cross-country risk-sharing and consumption smoothing, and stimulate growth and the post-COVID-19 recovery.

The measures we propose are broad in nature and require strong commitments, in line with the ECB's long-standing view that the CMU project has to be ambitious[4]. Accomplishing these reforms could trigger a virtuous cycle of better economic outcomes and further reforms, strengthening the European project. We recognise that developing and integrating European capital markets will primarily be a market-led process, so the measures we propose are designed to enable market forces.

Why is CMU even more important due to the COVID-19 crisis?

Even before the pandemic, the ECB was a strong supporter of the CMU project. CMU aims to deepen and further integrate capital markets in order to establish a genuine single capital market within the EU, which would allow investors, savers, firms and market infrastructures to access a full range of services and products, regardless of where they are located[5]. Let us explain why CMU matters, and why it is particularly important due to the COVID-19 crisis.

First, European firms would benefit from more diverse funding sources, which would allow them to adapt more effectively to changing funding conditions. Easier access to market-based financing instruments would lessen firms' reliance on bank financing when the banking sector has been weakened by a shock, such as the COVID-19 crisis. This would also support the smooth transmission of monetary policy.

Second, progress towards CMU would increase private risk-sharing across countries and actors, generating positive effects from a macroeconomic stabilisation perspective and making economies more resilient to local shocks. This is particularly important now, with the risk of diverging economic development within the euro area due to the shock from the pandemic.

Within Europe, increasing cross-border ownership of stocks and debt securities and cross-border business financing would be an important way of sharing risks and thereby stabilising households' consumption and firms' investment over time[6]. Equity markets tend to have particularly strong risk-sharing properties. Several studies also emphasise that equity funding is more resilient to shocks than debt funding, and can be considered more stable from a risk-sharing perspective[7].

Third, boosting capital markets through policies aimed at increasing equity financing would support growth and innovation. Research suggests that firms with higher growth potential generally resort more to (public or private) equity financing than debt financing and that capital markets are better at financing innovation and new sources of growth[8].

This makes capital market funding particularly attractive with a view to boosting Europe's potential growth after the pandemic. A fully fledged CMU would improve funding conditions for innovative firms, which would mean brighter prospects for jobs and growth in a more sustainable economy, thereby helping to successfully implement the structural changes that will be unavoidable after the crisis.

Fourth, advancing CMU would speed up the transition to a low-carbon economy. Recent analysis suggests that an economy's carbon footprint shrinks faster when it receives a higher proportion of its funding from equity investors than from banks or through corporate bonds[9]. Given equity investors' propensity to fund intangible projects, equity markets might be more successful in funding green innovation and supporting the reallocation to green sectors.

Fifth, integrated euro area capital markets would strengthen the international role of the euro, as deep and liquid financial markets are fundamental to a currency's ability to attain international status[10]. By reducing transaction costs, deeper markets would make using the euro more attractive for international financing and settlement. More liquid markets also mitigate rollover risk and are thus perceived as safer by investors.

A stronger international role for the euro would benefit our monetary policy, including through greater policy autonomy and improved monetary policy transmission, with positive spillbacks and lower external financing costs[11]. It would complement other measures supporting the international role of the euro, such as the expansion of euro liquidity facilities during the COVID-19 crisis[12].

"The COVID-19 pandemic has re-emphasised the importance of the CMU project and the need to make rapid progress"

Finally, progress on CMU would dovetail with another key EU objective: completing the banking union. Banks and capital markets complement each other in financing the real economy, so the two projects are mutually reinforcing[13].

On the one hand, more integrated capital markets support cross-border banking activities, as banks exploit economies of scale and offer similar capital market products across the EU.

More cross-border holdings would also allow banks to have more diversified collateral pools for their securitised products and covered bonds. This could ultimately make banks more resilient, as they would benefit from a wider investor base for capital market-based funding instruments and a broader market to which they could sell non-performing assets.

On the other hand, a more resilient and integrated banking system supports the smooth functioning and further integration of capital markets. Just as with CMU, the benefits of banking union become even more visible due to the pandemic.

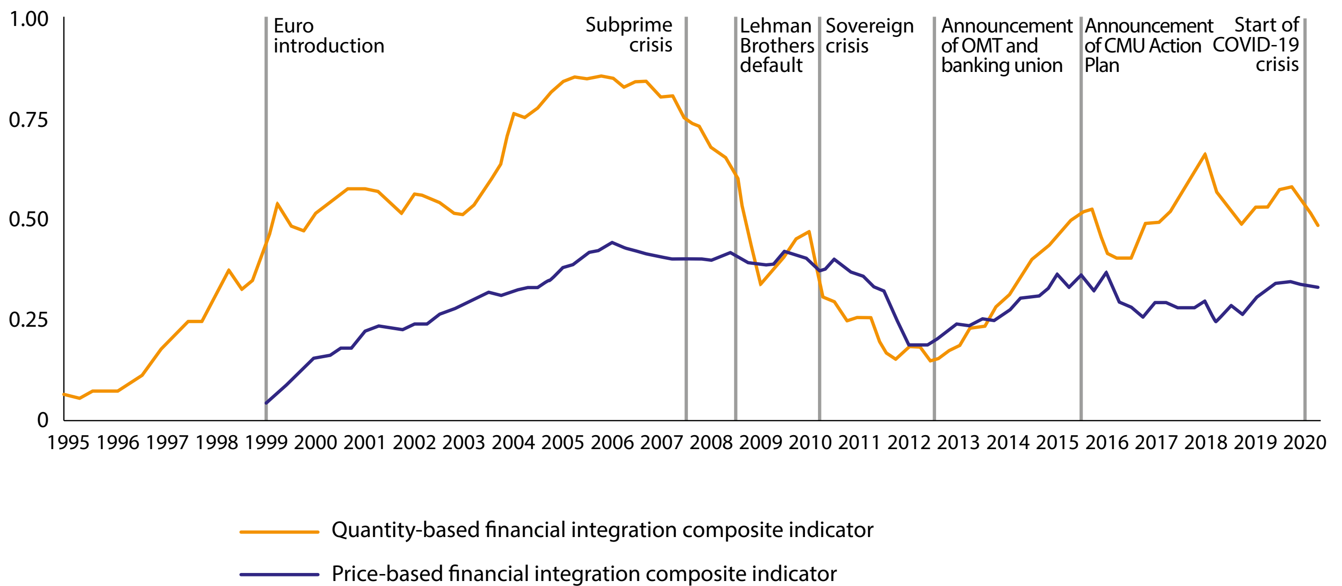
Where do European capital markets stand today and what has happened during the pandemic?

The first CMU Action Plan of 2015 has generated some positive developments in European capital markets. Among other things, it led to some progress on harmonising and improving insolvency frameworks[14]. and on establishing a new EU framework for covered bonds and simple, transparent and standardised securitisations. But a significant 'CMU effect' has yet to be seen in the data – partly because these measures have only been implemented recently and their full impact will take some time to emerge[15].

European capital markets – and especially equity markets – remain underdeveloped and insufficiently integrated at the European level. While there was a strong positive trend in capital market integration following the great financial and euro area crisis, as shown by the price- and quantity-based indicators in Chart 1, the integration of equity markets has stagnated since 2015 and has even declined since the fourth quarter of 2017.

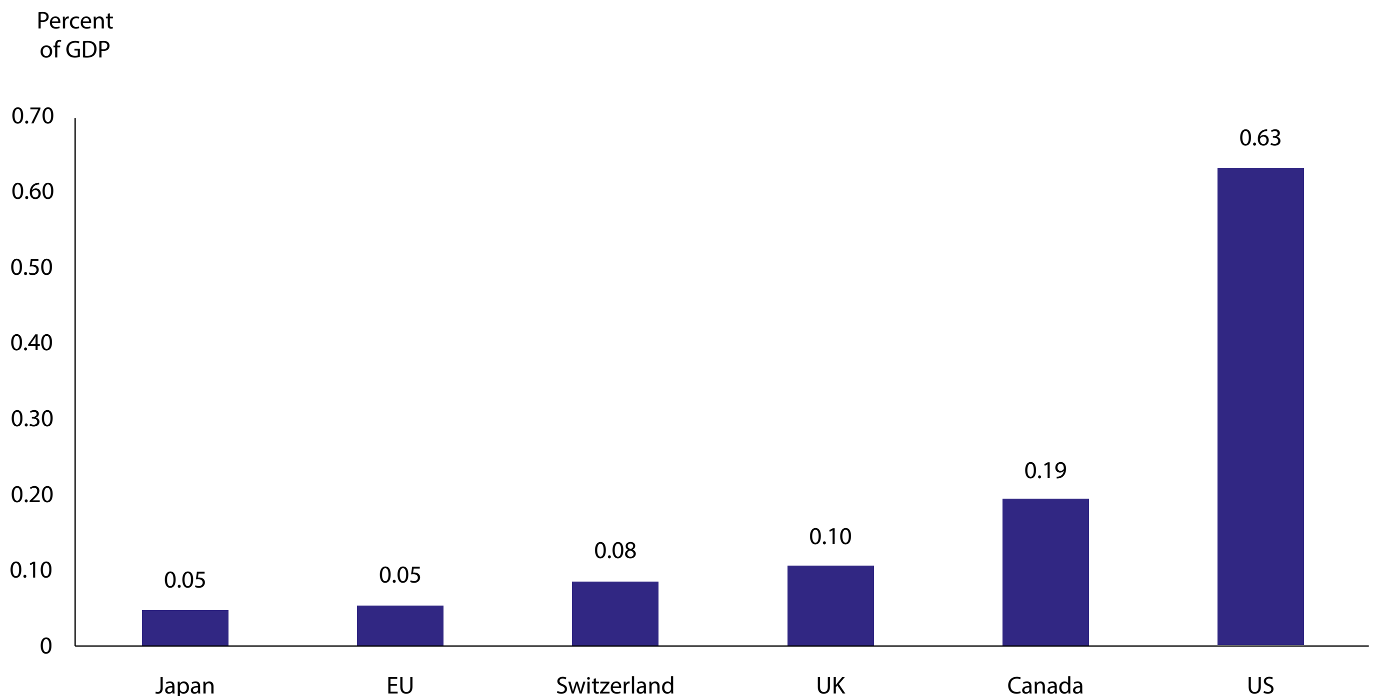
Cross-border holdings of debt have increased, but this is mainly true for shorter maturities, which are less stable than longer-term debt[16]. Another notable trend is that investment

Chart 1. Price and quantity-based indicators of financial integration



Notes: The indicators are bound between zero (full fragmentation) and one (full integration). The result of the quantity-based composite indicator for Q2 2020 is based on money market and equity market benchmark data from Q2 2020; for the bond market, Q1 2020 benchmark data are used. For a detailed description of the indicators and their input data, see the Statistical annex [https://www.ecb.europa.eu/pub/pdf/annex/ecb.fie202003_annex.en.pdf] to the ECB report "Financial Integration and Structure in the Euro Area" (see source below) and Hoffmann et al. (2019).
Source: ECB (2020), Financial Integration and Structure in the Euro Area [https://www.ecb.europa.eu/pub/fie/html/ecb.fie202003~197074785e.en.html], March 2020.

Chart 2. Venture capital investments in 2019



Notes: For Japan only 2018 data are available. Data for the EU show the average for all EU countries for which data are available. Data are not available for Croatia, Cyprus, Malta and Slovenia.
Sources: OECD and IMF World Economic Outlook.

funds are playing an increasingly important role in cross-border integration[17].

However, overall risk-sharing is still low compared with the levels typically observed across regions or states within a single country or federation[18].

While it is too early to fully assess the impact of the COVID-19 outbreak on EU capital markets, some initial indicators show that the pandemic has triggered a refragmentation within euro area financial markets, mainly through bond and equity markets. At the height of the pandemic, this meant that our private purchase programmes could not reach the non-financial corporations (NFCs) of all euro area countries in the same way[19].

Capital market development is also lagging behind[20]. While the US economy is financed through capital markets to a significant degree, the euro area economy continues to be mainly financed by banks and through unlisted shares.

Nevertheless, the role of capital markets in providing a stable source of funding to the European economy is expanding, thereby moving the euro area's financial structure towards a more balanced composition[21].

NFCs have gradually diversified their funding structures and are increasingly financing themselves in the market by issuing debt securities. At the same time, however, corporate bond markets are very uneven across euro area countries.

Even though the share of all equity instruments in total financing in the euro area is comparable to other countries, financing through equity traded on public markets (listed shares) remains relatively uncommon, and well below the levels seen in other major economies[22].

Conversely, loans and unlisted shares account for particularly large proportions of financing in the euro area economy. Similarly, the EU is lacking in early-stage private equity investment (see Chart 2). Data on venture capital investment relative to GDP show that even in Finland and Estonia, which are the most advanced EU countries in this area, the ratio is less than one-fifth of that in the United States.

Early-stage financing is not the only ingredient missing for innovative firms to flourish: the EU is also lagging behind the United States as regards an ecosystem that promotes the next stages of growth when firms mature and need to scale up their businesses[23].

European equity markets are underdeveloped for a number of reasons, all of which influence both the supply of, and demand for, equity finance[24]. One important element is investor behaviour: equity ownership by investors, in particular retail investors, is low despite the growth of the investment funds sector, and skewed in the population compared with the United States.

At present, only 9% of the adult population of the euro area own publicly traded shares, compared with 52% in the United States. The picture across the euro area is mixed, both in terms of retail investors' preferences across asset classes and in the overall level of household investments (see Chart 3).

Unsurprisingly, the equity share of private pension investment is particularly low in countries with large pay-as-you-go systems[25]. By contrast, countries with large funded pension systems and, therefore, large aggregate private retirement savings, typically have the most developed capital markets[26].

The flip side of Chart 3 and the limited investments in capital market products is that European savers hold large amounts of bank deposits.

Appropriate equity shares in funded pension systems would help to ensure satisfactory returns for citizens over the long periods of time relevant for retirement savings. Adequate diversification rules across European countries in the new pan-European Personal Pension Product would help improve private financial risk-sharing.

Another element is the interconnection between the structure of the EU economy and that of EU financial markets. Depending on the sectors in which they operate, firms may be better served by bank or market-based finance[27].

On the one hand, firms relying more on bank finance can be protected from the vagaries of investor sentiment[28]. On the other hand, a lack of market-based financing, particularly equity financing, can impede innovative firms in Europe from flourishing and becoming global champions, since banks – by contrast with venture capital or private equity firms – tend to finance less risky projects.

The size of firms also matters for financial structure. The large share of loans and unlisted shares in euro area NFCs' external financing sources (see Chart 4) partly reflects the larger share of small and medium-sized enterprises (SMEs) in the euro area.

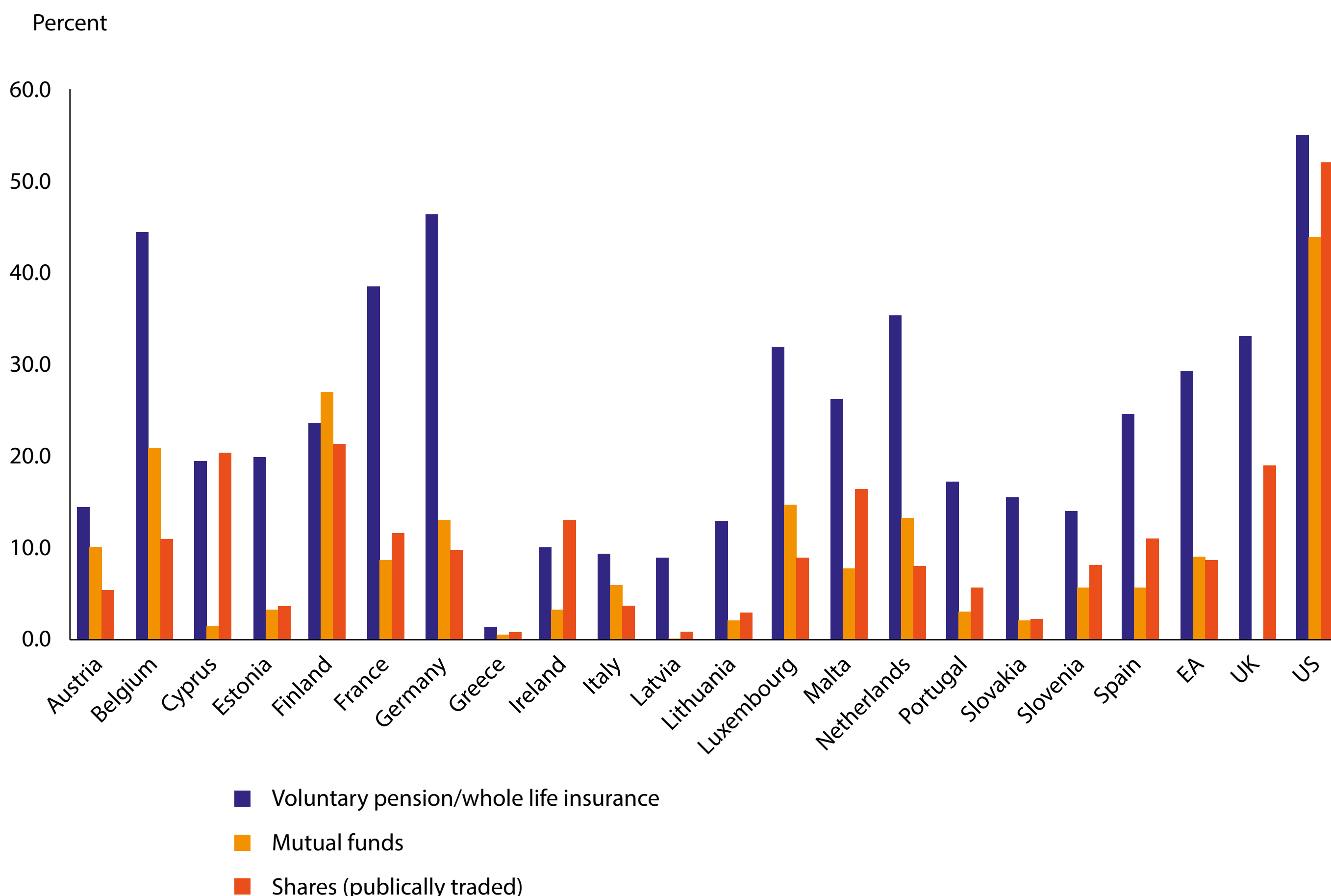
Research analysing the willingness of European SMEs to pay for external financing shows that they are willing to pay a non-negligible premium for debt funding, in particular in the form of bank loans, over external equity funding[29].

As this cannot be explained completely by factors such as the debt-equity bias in taxation, the same research suggests that the bank-based system may have created a bias towards those types of firms that are better served by debt finance rather than equity finance, which may hamper innovation.

While additional research would be needed to pinpoint other factors explaining the reluctance of EU firms – especially smaller ones – to become publicly listed, oft-cited drivers include the burden of the increased transparency and reporting requirements that result from public listing, a preference for relationship-based funding, or concerns about loss of control and dilution of existing shareholders.

Legislative proposals recently published by the European Commission in response to the COVID-19 crisis intend to reduce some of the red tape associated with listing[30].

Chart 3. Share of households holding different asset classes by country



Notes: Chart shows shares of asset types relative to the value of real assets by household (in percentages) from the ECB's Household Finance and Consumption Survey. All data are from 2014 with the exception of Estonia, Ireland, Malta, Netherlands, Portugal and Finland (2013) and Spain (2011). Data on mutual funds for the United Kingdom were not available.
Sources: ECB's Household Finance and Consumption Survey, Forbes, ICI and Gallup.

A roadmap for CMU

The European Commission's new CMU Action Plan should be ambitious and aim to bring out the full potential of well-developed equity markets and integrated EU capital markets in order to stimulate both the demand for, and supply of, capital market instruments and services. Priority should be given to the following mutually reinforcing areas[31]:

1. Regulation and legal frameworks
2. Supervision and oversight
3. Fiscal policy and public debt markets
4. Financial market development
5. Securitisation

Regulation and legal frameworks

EU capital markets must be able to rely on common rules and regulatory policies that support a level playing field for all market participants. The single rulebook must be strengthened and applied consistently throughout the EU.

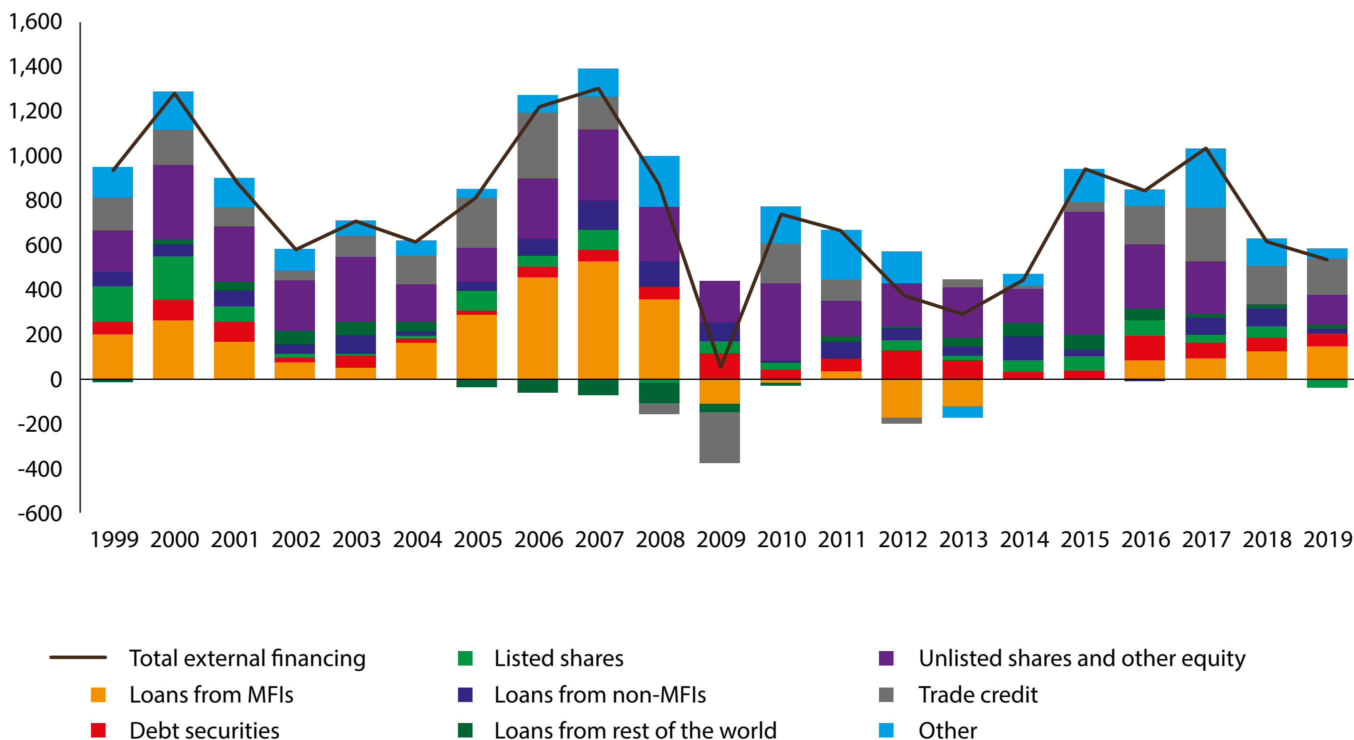
Despite the objective to create a single European market for financial services, non-EU service providers still have to navigate a patchwork of regimes adopted at member state level in order to access national markets. A single, unified approach is needed, particularly in view of the level playing field challenges that might appear after Brexit.

Standardisation and harmonisation are instrumental in developing new markets. A case in point is the green bond market where the EU is already the global leader[32]. A reliable, verifiable and transparent EU green bond standard based on the EU Taxonomy would significantly enhance the credibility of this asset class.

To serve its purpose and prevent greenwashing, the EU green bond standard must strike a balance between being selective in financing investment projects and avoiding disproportionately strict rules for issuers.

Chart 4. External financing of euro area NFCs by instrument

Annual flows;
€ billions;
1999-2019



Notes: "MFIs" stands for "monetary financial institutions". Non-MFIs include other financial institutions as well as insurance corporations and pension funds. "Other" is the difference between the total and the instruments included in the chart, and includes inter-company loans and the rebalancing between non-financial and financial accounts data. 2019 data refer to data for the end of the third quarter of 2019.
Sources: ECB (euro area accounts) and ECB calculations.

Collecting, processing and disclosing data will become ever more relevant for market players. For example, it is still challenging for investors to perform due diligence in relation to the management of European equity portfolios since relevant company information is widely scattered across multiple databases and has generally not been harmonised across borders.

An adequately designed European Single Access Point, developed under the lead of the European Securities and Markets Authority, would provide investors with centralised access to all relevant financial, trading and regulatory information on European companies and their securities.

In the longer term, further harmonisation of general legal frameworks would be desirable. Investors must be able to trust the predictability of the legal framework.

In particular, market participants would find it easier to invest in firms located in different member states if core elements of insolvency regimes, such as the definition of insolvency triggers, avoidance actions and the ranking of claims, were harmonised at best-practice levels[33].

If full harmonisation of these regimes seems unfeasible, the development of dedicated EU-level regimes or procedures should be considered.

Supervision and oversight

Given that risks do not stop at the EU's internal borders, there is a strong case for implementing EU-wide supervision of capital markets. This could also ensure consistent implementation of the single rulebook to provide a level playing field for investors and market players.

In particular, capital markets can only function smoothly if they can rely on efficient and robust market infrastructures. Additional efforts to better integrate and supervise key market infrastructures are essential to ensure a level playing field for issuers and investors. This could include genuine EU-level supervision of systemically important EU central counterparties and greater supervisory convergence for

central securities depositories by promoting the centralisation of supervisory powers (or at least enhanced cooperation at EU level), as well as launching efforts to ensure that reliable infrastructures are in place to deal with more sophisticated cyber threats[34].

Fiscal policy and public debt markets

To promote the development of capital markets, national tax frameworks should avoid distorting incentives for firms and investors regarding capital structure. In particular, the existing bias in favour of debt over equity should be addressed in a decisive manner to facilitate the issuance of listed equity by firms[35].

Further simplification and cross-border convergence of withholding tax procedures would reduce the administrative burden for cross-border investors. This could pave the way for the development of a common, adequately designed, sovereign safe asset, which could have important benefits for financial stability, integration and development in the euro area[36].

The issuance of a low-risk security at European level would enhance the financial system and would be an important component in developing a proper euro area term structure[37].

The EU joint debt issuance for the establishment of the European recovery fund could represent a first step in this direction, as the current proposal includes a plan to issue EU-level bonds with different maturity dates between 2028 and 2058. A safe asset of this nature could lead to the emergence of a genuine single securities market in the EU.

In contrast to other currency areas, financial integration and risk-sharing among market participants in the euro area is impeded by the current lack of a pan-European, neutral and harmonised channel for the issuance and initial distribution of debt securities that would address the fragmentation of debt markets along national lines.

Financial market development

Efforts to improve financial literacy would support the CMU agenda and, more importantly, allow households to reap the benefits of capital markets. Citizens would then be better equipped to critically assess investment advice and broaden their long-term investment options[38].

We would welcome initiatives from the European Council and Commission to make financial literacy a priority in lifelong learning and to develop an EU competence framework. The same goes for proposals that seek to ensure the provision of adequate and fair advice and thus improve retail investors' trust in advisers and capital markets[39].

It would be useful to identify best practices for financial education initiatives, and member states themselves could devise further initiatives with a broad impact in the long term, such as incorporating financial education into secondary school curricula.

A further major determinant of financial market development is the structure of pension schemes. While we recognise the profound social choices involved in designing national pension systems, we also note that increasing private retirement savings rates in response to demographic changes could have a strong positive impact on European capital markets[40].

Adequate options for portfolio compositions, including various choices about the equity share and (European cross-country) diversification (as embedded in the new pan-European Personal Pension Product, for example), would offer households opportunities to improve their retirement incomes.

The European long-term investment fund was designed to address the lack of equity funding for innovative and young firms. However, this instrument has so far not worked as expected and should be amended in a targeted fashion, for example by increasing the investor pool and simplifying applicable tax rules. Firms could then attract more cross-border and retail investors.

In addition, in the light of the unavoidable increases in debt in order to finance the post-COVID-19 recovery and potential defaults, European markets for trading impaired assets should be better developed and integrated.

Securitisation

Securitisation allows banks to transfer parts of the risks associated with their lending to other investors and can therefore broaden companies' investment bases and funding conditions.

While the new European framework for simple, transparent and standardised securitisation (finalised in 2017) has dealt with the weaknesses and excesses that contributed to the financial crisis of 2008, it has not proven fully effective in reviving the much-reformed EU markets.

A review should be conducted to explore how existing rules could be improved. This could include options for facilitating the securitisation of impaired assets.

Conclusion

Advancing CMU is not just about capital markets and financial institutions. It will be of benefit to all of us, entrepreneurs, employees, savers and citizens alike. The COVID-19 pandemic has re-emphasised the importance of the CMU project and the need to make rapid progress. We should be realistic that the benefit to be gained from some measures will take longer to emerge than others.

For instance, while further harmonising insolvency frameworks or integrating financial literacy into school curricula could have a very significant impact, it will be many years before we see the related effects.

But other measures, such as the creation of a European Single Access Point for company information or the removal of the tax advantage of debt, could be implemented over a relatively short time period and would have near-term implications.

Most importantly, it could facilitate the structural changes that have become unavoidable as a result of the pandemic and support the transition to a low-carbon and digitalised economy. The COVID-19 crisis is thus a wake-up call to strengthen CMU and make the EU economy more robust and resilient. ■

Endnotes

1. See Panetta, F (2020), "Sharing and strengthening the euro's privilege" [https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200612~312fc9d1dc.en.html], The ECB Blog, 12 June.

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3. Several recent reports include suggestions on CMU from market participants and policymakers. See European Commission (2020), "Final report of the High Level Forum on the Capital Markets Union - A new vision for Europe's capital markets" [https://ec.europa.eu/info/files/200610-cmu-high-level-forum-final-report_en]; The Next CMU High-Level Expert Group (2019), "Savings and Sustainable Investment Union"; Panagiotis, A. and Wright, W (2019), "Report: Unlocking the growth potential in European capital markets" [https://newfinancial.org/report-unlocking-the-growth-potential-in-european-capital-markets/], New Financial; Lannoo, K and Thomadakis, A (2019), "Rebranding Capital Markets Union: A market finance action plan" [https://www.ceps.eu/wp-content/uploads/2019/07/Rebranding-Capital-Markets-Union.pdf], CEPS-ECMI Task Force; Bhatia, VA et al. (2019), "A Capital Market Union for Europe" [https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2019/09/06/A-Capital-Market-Union-For-Europe-46856], Staff Discussion Notes, IMF; and AFME (2018), "Capital Markets Union: Measuring progress and planning for success" [https://www.afme.eu/portals/0/globalassets/downloads/publications/afme-cmu-kpi-report-3.pdf].

4. See ECB (2017), "ECB contribution to the European Commission's consultation on Capital Markets Union mid-term review 2017" [https://www.ecb.europa.eu/pub/pdf/other/ECB_contribution_to_EC_consultation_on_CMU_mid-term_review_201705.en.pdf], May.

5. For the ECB, "the market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics: (1) face a single set of rules when they decide to transact in those financial instruments and/or services; (2) have equal access to the above-mentioned set of financial instruments and/or services; and (3) are treated equally when they are active in the market". See Baele, L et al. (2004), "Measuring financial integration in the euro area" [https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp14.pdf], Occasional Paper Series, No 14, ECB, April.

6. See Beck, R, Dedola, L, Giovannini, A and Popov, A (2016), "Financial integration and risk sharing in a monetary union" [https://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201604.en.pdf], Financial Integration in Europe, April, ECB.

7. Equity contracts imply gains for stock owners in good times but losses in bad times, whereas debt contracts are characterised by fixed payments over the life of the contract. Studies showing the positive effects include: Artis, MJ and Hoffmann, M (2012), "The Home Bias, Capital Income Flows and Improved Long-Term Consumption Risk Sharing between Industrialized Countries", International Finance, Vol. 13, No 3, pp. 481-505; Forbes, KJ and Warnock, FE (2014), "Debt- and Equity-Led Capital Flow Episodes", in Fuentes, M, Raddatz, CE and Reinhart, CM (eds.), Capital Mobility and Monetary Policy: An Overview, Chapter 9, Central Banking Series, Central Bank of Chile, pp. 291-322; and Milesi-Ferretti, GM and Tille, C (2011), "The Great Retrenchment: International Capital Flows During the Global Financial Crisis", Economic Policy, Vol. 26, No 66, pp. 285-342.

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9. See De Haas, R and Popov, A (2019), "Finance and carbon emissions", [https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2318~44719344e8.en.pdf] Working Paper Series, No 2318, ECB, September; and Popov, A (2020), "Does financial structure affect the carbon footprint of the economy?" [https://www.ecb.europa.eu/pub/fie/html/ecb.fie202003~197074785e.en.html#toc8], Financial Integration and Structure in the Euro Area, March, ECB.

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11. For the different dimensions of how the international role of the euro affects monetary policy transmission, see Cœuré, B (2019), "The euro's global role in a changing world: a monetary policy perspective" [https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190215~15c89d887b.en.html], speech at the Council on Foreign Relations, New York City, February; and Gräb, J and Mehl, A (2019), "The benefits and costs of the international role of the euro at 20" [https://www.ecb.europa.eu/pub/ire/html/ecb.ire201906~f0da2b823e.en.html#toc15], The international role of the euro, June 2019, ECB.

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13. See Constâncio, V (2017), "Synergies between banking union and capital markets union" [https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170519_1.en.html], keynote speech at the joint conference of the European Commission and European Central Bank on European Financial Integration, Brussels, 19 May.

14. Through Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019L1023&from=EN] on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.

15. See de Guindos, L (2019), "Building the EU's capital markets: what remains to be done" [https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190523~b1245030d5.en.html], speech at the Association for Financial Markets in Europe Conference, Supervision and Integration Opportunities for European Banking and Capital Markets, Frankfurt am Main, 23 May.

16. See ECB (2020), Financial Integration and Structure in the Euro Area [https://www.ecb.europa.eu/pub/fie/html/ecb.fie202003~197074785e.en.html], March.

17. See, for example, Giuzio, M and Nicoletti, G (2018), "Integrating euro area corporate bond markets: benefits and potential financial stability challenges" [https://www.ecb.europa.eu/pub/pdf/fie/ecb.financialintegrationineurope201805.en.pdf], Financial integration in Europe, May. Funds that are domiciled in financial centres facilitate the diversification of asset holdings across euro area countries, see Vivar, LM, Lambert, C, Wedow, M and Giuzio, M (2020), "Is the home bias biased? New evidence from the investment fund sector" [https://www.ecb.europa.eu/pub/fie/article/html/ecb.fieart202003_03~9efb363a78.en.html], Financial Integration and Structure in the Euro Area, March, ECB.

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20. One way of defining financial development (or financial modernisation for an already highly developed financial system like that of the euro area) that is also applicable to capital markets is the process of financial innovation, as well as institutional and organisational improvements in the financial system that reduce asymmetric information, increase the completeness of markets and contracting possibilities, reduce transaction costs and ensure a high level of competition. See the preface to ECB (2020), op. cit.; and ECB (2008), "Financial development: concepts and measures" [https://www.ecb.europa.eu/pub/pdf/fie/financialintegrationineurope200804en.pdf], Financial integration in Europe, April.
21. The data in this paragraph are taken from ECB (2020), ibid.
22. Stock market capitalisation was 56% in the EU27, 163% in the United States, 149% in Japan and 110% in the United Kingdom. The data are taken from the 2019 ECMI Statistical Package [https://www.ecmi.eu/statistical-packages].
23. See Lannoo, K and Thomadakis, A, op. cit.
24. These include cultural barriers to equity investment, unavailability of uniform firm information, biases in taxation, low levels of financial literacy, the design of pension systems and products, low public investment in fundamental research and more market-oriented research and development, and the lack of technology clusters.
25. The equity share is less than 20% in the median EU country, compared with 30% in Switzerland, 44% in the United States and 51% in Australia. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), "Financial integration, capital market development and risk sharing in the euro area" [https://febs2018.ccmgs.it/wp-content/uploads/2018/06/2018-06-04-Private-Risk-Sharing-Keynote-at-the-Financial-Engineering-and-Banking-Society-International-Conference-in-Rome-public-by-P-Hartmann.pdf], keynote speech at the 8th International Conference of the Financial Engineering and Banking Society, 4 June.
26. See, for example, Scharfstein, D (2018), "Presidential address: Pension policy and the financial system", Journal of Finance, Vol. 73, No 4, pp. 1463-1512.
27. See, for example, Rajan, RG and Zingales, L (2003), "Banks and markets: the changing character of European finance", in Gaspar, V., Hartmann, P and Sleijpen, O (eds.), The Transformation of the European Financial System, Proceedings of the Second ECB Central Banking Conference, Frankfurt am Main, pp. 123-167; Rajan, RG and Zingales, L (2001), "Financial Systems, Industrial Structure, and Growth", Oxford Review of Economic Policy, Oxford University Press, Vol. 17, No 4, pp. 467-482; and Hall, P and Soskice, D (2001), Varieties of capitalism: the institutional foundations of comparative advantage, Oxford University Press.
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29. See, for example, ECB (2020), op. cit.; and Brutscher, PB and Hols, C (2018), "The corporate equity puzzle" [https://www.eib.org/en/publications/economics-working-paper-2018-03], EIB Working Papers, 2018/03.
30. European Commission (2020), "Coronavirus response: Making capital markets work for Europe's recovery" [https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1382], 24 July.
31. Some of these proposals were included in the High Level Forum's report on CMU and in other reports mentioned above (see footnote 3 for more details).
32. In 2019 more than half of global issuance was concentrated in the EU and almost half of global green bond issuance was denominated in euro. For more details, see ECB (2020), "The international role of the euro" [https://www.ecb.europa.eu/pub/ire/html/ecb.ire202006~81495c263a.en.html], June.
33. Research finds that improving insolvency frameworks in euro area countries towards best practice enhances private financial risk-sharing through capital markets. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), op. cit.
34. The ECB has played a key role in fostering public-private cooperation, for example by launching a new cyber-threat intelligence sharing platform for market infrastructures under the Euro Cyber Resilience Board. See Panetta, F (2020), "Protecting the European financial sector: the Cyber Information and Intelligence Sharing Initiative" [https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200227~7aae128657.en.html], introductory remarks at the fourth meeting of the Euro Cyber Resilience Board for pan-European Financial Infrastructures, February.
35. As part of the 2015 Action Plan on Building a Capital Markets Union, the European Commission proposed relaunching work on the common consolidated corporate tax base, including a legislative proposal [https://ec.europa.eu/taxation_customs/business/company-tax/corporate-tax-reform-package_en_en], which has still not been agreed on by the European Council. Research shows that allowing firms to deduct a notional interest rate on equity against their profits (on top of the existing deductibility of interest expenses) is likely to be beneficial for financial stability as, in the case of Belgium and Italy, it effectively reduced firms' leverage. See, for example, Hebous, S and Ruf, M (2017), "Evaluating the effect of ACE systems on multinational debt financing and investments" [https://www.sciencedirect.com/science/article/pii/S0047272717300245], Journal of Public Economics, Vol. 156, pp. 131-149; and Schepens, G (2016), "Taxes and bank capital structure" [https://www.sciencedirect.com/science/article/pii/S0304405X16000209], Journal of Financial Economics, Vol. 120, Issue 3, pp. 585-600.
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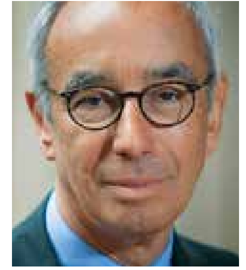
37. See also Panetta, F (2020), "Sharing and strengthening the euro's privilege" [https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200612~312fc9d1dc.en.html], The ECB Blog, 12 June.
38. Research finds that levels of financial education vary widely across the euro area, and that financial literacy enhances capital market participation and fosters private financial risk-sharing via capital markets. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), op. cit.
39. See the High Level Forum's report on CMU (European Commission (2020), op. cit.) for specific proposals regarding inducements for financial advisers and how to enhance the quality of financial advice.
40. For example, an estimation of the impact for the euro area if all member countries increased the share of equity investments in their pension savings to a "regular" level for diversified long-term portfolios (about 39%) shows that the additional equity demand would amount to about 3.7% of total equity market capitalisation. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), op. cit.

This article is based on The ECB Blog [https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200902~c168038cbc.en.html], 02 September 2020

Financing the European Union: new context, new responses



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Roughly two thirds of the European Union's budget is financed out of member states' national tax revenues. These resources, based on gross national incomes, are transparent, fair and in line with the principle of subsidiarity but they lead to political debates that emphasise the cost of EU spending rather than the benefits, and add to the perception of the EU budget in terms of net balances, rather than value added.

The financing of the EU budget must be reassessed in the light of the July 2020 decision to launch the Next Generation EU programme. Budget resources could include a plastics charge, a carbon border adjustment mechanism, a digital tax, revenues from emissions trading and a financial transactions tax.

We evaluate these options against four criteria: whether the origin of the revenue can be assigned to a particular member state; whether the revenue can be raised in isolation or requires pan-European tax coordination; whether the new resource can help reduce tax distortions in the EU; and whether the resource is related to EU policies.

Revenues from emissions allowances fit these criteria best. Carbon emissions do not primarily cause damage only where they occur. Taking the EU cap on emissions as a given, additional emissions in a particular member state should be regarded as a negative externality on other member states. Emission reduction objectives are set at EU level.

Whoever auctions off an allowance, wherever the corresponding emission occurs in the EU, and wherever the resulting good or service is consumed, the impact on common policy outcomes is the same. In this regard, proceeds from the sale of emissions trading system allowances are not that different from customs duties.

Compared to the ETS, the other candidates for EU own resources are less convincing. Carbon border adjustments are intended to limit international competitive distortions rather than to generate revenue. Digital taxes and minimum corporate taxes are best left to the process underway in the Organisation for Economic Co-operation and Development. On a financial transactions tax there is no agreement within the EU.

Total ETS revenues up to 2050 would approach €800 billion in a realistic scenario and possibly even €1.5 trillion assuming the scope of the ETS and the share of auctioned permits are increased. ETS revenues therefore would be largely sufficient to repay the Next Generation EU debt.

However, they would generate distributional effects, and so part of the revenues should finance grandfathered rights that would accrue to the member states. The EU can tackle the distributional issues involved in the reform of own resources.

Introduction

The debate on the financing of the European Union budget is never-ending. Because it is overly loaded with quasi-constitutional, and at any rate highly political considerations about the nature of the EU, it has consistently served as a battlefield between those who regard the EU as a confederation of sovereign states and those who believe in its federal destiny.

We have no intention of reopening the existential debate. But we posit that two new facts call for a pragmatic re-examination of the financing of the EU budget:

- The decision by the European Council to launch the Next Generation EU (NGEU) recovery programme in response to the COVID-19 crisis.

  In its conclusions, the European Council of July 2020 requested from the Commission proposals for new own resources that could be used for early repayment of NGEU borrowing;

- The emergence of potential new resources that have an intrinsically pan-European character.

We start by reviewing the financing of the EU. We then turn to arguments for or against reforming the existing system, before putting forward criteria for assessing potential new resources. We then take up the potential revenue implications of climate policy, dealing first with the emissions trading system and second with the taxation of carbon at the border.

We discuss digital taxation and other potential candidates for own resources, especially the financial transaction tax. As this

"The decision to introduce new resources is ultimately political and the discussion about it is likely to involve strong distributional aspects"

analysis leads us to conclude that there is a strong case for turning ETS revenues into an EU own resource, we return to the issue to discuss implementation issues.

The financing of the EU budget

The EU budget has a number of characteristics that make it unique. There is a fixed ceiling on revenues and spending, and there is no debt financing – with the exception of the recent €750 billion EU Economic Recovery Fund (Next Generation EU), which was announced as a one-time measure.

The revenue comes from so-called 'own resources'. This is a misnomer that combines genuine own resources (the 'traditional own resources', mostly tariffs) and statistical aggregates (the VAT resource and the gross national income resource). Custom duties are true own resources because they are levied at the port of entry of foreign merchandises, but result from demand emanating from wherever in the EU the corresponding goods are consumed or utilised.

After deducting a fee for administration costs (currently 20 percent of the revenue), the remainder goes to the EU. The VAT resource and the GNI resource, however, are levied by each and every member state and are widely considered by them as national contributions to the EU budget, not as resources 'owned' by the EU.

In recent years the EU budget has been financed essentially by the GNI resource. However, this resource was only introduced in the early 1990s (Figure 1). Earlier budgets were mostly financed by the VAT resource and the custom duties, the share of which in total revenues was about one-half in 1980.

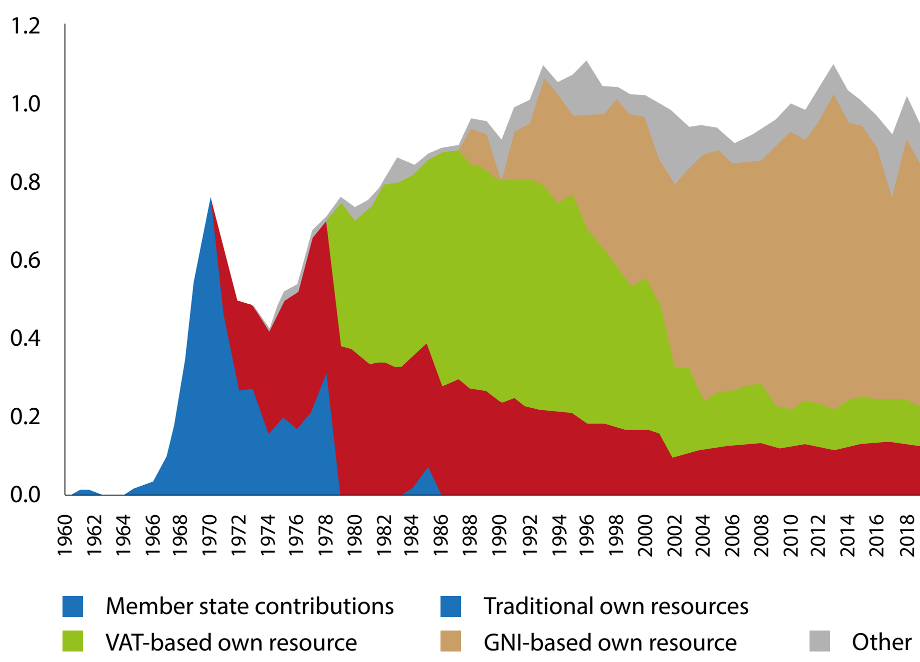
In fact, the structure of EU budget resources has been remarkably unstable over time, evolving from an exclusive reliance on national contributions (before 1970) to a combination of genuine own resources and a VAT top-up (from the mid-1970s to the 1980s) and to a renewed predominance of national contributions (from the 1990s onwards) (Cipriani, 2014).

Today, the GNI resource provides roughly two thirds of the overall financing of the EU budget. Given this revenue structure, it is fair to say that the EU budget is primarily financed through contributions made by the member states out of national tax revenue.

This instability results from a legal factor and an economic factor. The legal factor is that although Art. 311 of the Treaty on the Functioning of the European Union (TFEU) states that *"Without prejudice to other revenue, the budget shall be financed wholly from own resources",* it does not define what is meant by that, nor does it provide any detail on possible resources.

It basically leaves to the Council the responsibility of deciding by unanimity what these resources should be: the Council *"may establish new categories of own resources or abolish an existing category."* The economic reason is that the genuine own resources the EU relied on after the 1970 decision to *"replace financial contributions from member states by the communities' own resources"* were unstable: revenues from tariffs dwindled as a consequence of trade liberalisation, and

Figure 1. Structure of own resources of the European Community/EU, 1958-2018



Source: European Commission, DG Budget.

other specific revenues were too limited in the first place to provide stable revenue streams[1].

Why change the system of own resources?

In the debate about reform of the own resources system, it is important to distinguish two questions. The first is whether the EU should have its own – possibly limited – power to levy resources through taxation, rather than relying on the fiscal sovereignty of its member states.

This debate is about fundamental changes to the institutional setup of the EU, which would move it closer to a federal structure.

The other question is whether the system of own resources should be changed given the current institutional setup, with a fixed ceiling on expenditure, no deficit financing and national fiscal sovereignty as the bases for the financing of the EU.

We focus on the second question, that is on reforming the own resources system, taking as given the current EU institutional setup.

Discussions about reform of the EU own resources system often start from the (undisputable) observation that the existing system of financing is dominated by the GNI resource. Whether this dominance is good or bad is disputed.

The GNI resource has a number of advantages: it is transparent, it leads to a distribution of the financing burden between member states that is proportional to their respective capacities, and it allows member states to finance their contributions through the taxes that are best suited to local conditions and local preferences, which is in line with the principle of subsidiarity.

There are two main critiques of the dominance of the GNI resource. First, it is perceived as having a distorting effect on political decisions in the member states about the EU budget.

The High Level Group on Own Resources (HLGOR), which was created in 2014 to propose reforms to the own resources system, described this issue as follows:

> *"Member states that are net contributors to the EU budget first look at their contribution on the revenue side — and try to minimise this amount as much as possible. The costs are immediately visible whereas the consequent benefits are often indirect and more dispersed."*[2]

A related observation is that the dominance of GNI contributions encourages thinking about the EU budget in terms of net balances. Perceiving benefits from the EU budget as being reflected by net balances would be appropriate if the budget consisted purely of transfers between member states, essentially leading to a zero-sum game.

But EU spending on public goods that benefit all member states and their citizens, and that creates added value that benefits the EU economy as a whole, cannot be looked at through such a lens. Therefore, to the extent that European public goods are financed through the EU budget, net balances are a misleading measure of national benefits from this budget[3].

"Dominance of GNI contributions encourages thinking about the EU budget in terms of net balances, though EU spending creates added value that benefits the EU economy as a whole"

The second critique is that, in the same way customs duties were naturally allocated to the common budget in a customs union, the financing of the EU through GNI contributions ignores potential resources that, because of their genuinely European character, should be regarded as an efficient source of funding of the EU budget.

This applies, first, to tax bases that have by nature a pan-European character and cannot be mobilised by individual member states, and second to mobile tax bases that can only be taxed if member states coordinate their policies.

Potential candidates for such new own resources are for example levies on the carbon content of imports, which should not accrue to the country where the port of entry is located and whose ultimate destination inside the single market is hard to trace; or taxes on profits of multinational companies if they evade taxation through profit shifting unless states coordinate their policies.

Naturally, the existence of such resources is not by itself a justification for spending more at EU level, and the corresponding revenue could simply be redistributed to the member states proportional to their GNI. It would however be more efficient to allocate these resources directly to the financing of the EU budget.

Criteria for introducing new resources

Irrespective of the pros and cons of GNI-based resources, it is fruitful to discuss options for introducing new own resources. Most likely, these resources would complement but certainly not entirely replace GNI-based contributions.

Taking the volume of spending in the EU budget as given, introducing new own resources would imply a reshuffling of the burden of the financing of the EU across member states. GNI-based contributions would presumably keep the function of balancing the budget at the margin, but their weight would be mechanically reduced.

In the case of a new own resource based on existing national tax instruments, the impact would essentially be distributive, to the extent that the incidence across member states of the new resource differs from the distribution of GNI. There would be no first-order efficiency gain to speak of.

"Emissions trading revenues should accrue to the EU, rather than to the member state where the emissions take place"

But if the tax base was genuinely EU-wide, or if it is sufficiently mobile to avoid taxation by individual member states, the introduction of the new own resource would lead to lower taxation on other factors.

It would therefore result in a change in the structure of taxation and a reduction of existing tax rates, potentially yielding efficiency gains.

The decision to introduce new resources is ultimately political and the discussion about it is likely to involve strong distributional aspects. However, it is important that this decision be based on objective criteria. We suggest the following:

- Whether the origin of the revenue can be assigned to a particular member state;
- Whether the corresponding revenue can be raised in isolation or requires pan-European tax coordination;
- Whether the introduction of the new resource can help reduce tax distortions in the EU;
- Whether the resource is related to EU policies.

More than one of these criteria should be satisfied. For example, revenues that can be assigned to a member state and can be raised without coordination do not add anything to the public finance equation and therefore are not suited in any particular way to serve as an own resource, even if they correspond to the EU's political priorities.

The focus should be on where a strong case can be made for using tax instruments as a basis for own resources. This applies in particular to revenues that are European by nature because they can only be levied via a common decision, or cannot be ascribed to any particular member state in a meaningful way.

The introduction of such resources would both broaden the tax base, potentially reducing distortions, and increase the proportion of the EU budget that is financed from 'truly' European revenue sources.

Customs duties, for instance, were particularly suited as an EU own resource because it would not be appropriate to allocate the revenue to the country where the port of entry for the imported goods is located.

In addition, customs duties are related to trade policy, which is a competence of the EU. At its meeting on 17-21 July 2020, the European Council decided that the EU should work towards the introduction of new own resources.

The council conclusions explicitly mention a charge on non-recycled plastic, a carbon border adjustment mechanism, a digital tax, a reformed emissions trading system (ETS), and finally a financial transaction tax.

The timing of these potential new own resources is important. The plastics charge is agreed to start already in 2021, the border adjustment mechanism and the digital levy are to be introduced in 2023. There is no specified timetable for the ETS.

The financial transaction tax is mentioned as a potential project for the next MFF, which implies that it will play no role in the current reform of the own resources system. The revenues are to be used, among other things, to service the debt incurred for the EU Recovery Fund[4].

In the following, we focus primarily on the suitability of two types of potential new resources: carbon-related levies (through the auctioning of emission allowances within the framework of the ETS, and through a potential carbon border adjustment mechanism), and taxes on the profits or the revenues from the cross-border provision of digital services.

We also discuss a number of other potential bases for own resources, albeit with less detail: the financial transaction tax, the tax on non-recycled plastic and the corporate income tax.

Some of the candidates for new own resources, such as a corporate income tax or financial transaction tax, have a presumably permanent character, while others have a temporary character, either because their tax base is set to shrink (not least because that is the very purpose of the taxation), as is the case for carbon levies, or because they are temporary fixes (as for the digital services tax, if international discussions on new cooperative arrangements for corporate income taxation lead to a comprehensive redefinition of taxing rights).

Clearly, the EU budget should be financed by permanent resources, but as a consequence of recent decisions, temporary revenue is needed to service and pay down the debt incurred in the context of the NGEU Fund. Given this, a revenue source which is available for a limited amount of time may be appropriate.

Of course, the EU will need own resources for other purposes, but using temporary resources for a transition period would buy time to develop other options.

Revenues from the emissions trading system

The EU has ambitious climate policy objectives. All but one of the member states have endorsed the goal of reaching EU-wide climate neutrality in 2050, but this political commitment has not yet been translated into an operational strategy[5]. Current climate policy is based on a framework that includes EU-wide targets and policy objectives for the period from 2021 to 2030.

This framework, which also represents the EU contribution to the Paris Agreement, notably entails a 40 percent greenhouse gas emissions reduction target by 2030 (compared to 1990),

as well as renewable energy and energy efficiency targets. President von der Leyen has committed to revise this framework, raising the emissions reduction target to 50-55 percent by 2030.

The main EU policy tool to translate these objectives into practice is the ETS, which covers emissions from the power sector, industry and intra-EU flights (ie. about 45 percent of total EU emissions). Non-ETS sectors (ie. transport, buildings and agriculture) are dealt by the Effort Sharing Regulation (ESR, Regulation (EU) 2018/842), which requires member states to pay fines if they fail to reach them.

In the medium term it would be desirable to expand further the scope of the ETS and to bring in more sectors. The same carbon price would then apply to all participating sectors, which would ensure consistency and efficiency. Ultimately, all sectors could be brought in.

It would also be desirable to give up national objectives, because they are incompatible with the EU-wide, cost-efficient reduction of emissions. The proper basis for sharing efforts between member states should be the marginal cost of emission reductions.

If a member state can exceed its national objective at cost that is lower than the cost for another member state to reach its goal, the common interest dictates that the first country should make the effort, even if it is not in accordance with preassigned objectives.

Consistent with this approach, ETS revenues should accrue to the EU, rather than to the member state where the emissions take place. Allocation of revenues from the ETS to a particular member state is perfectly feasible: the location of emissions is precisely defined.

But there is no reason why proceeds from the sale of emissions permits should accrue to the country where emissions are taking place. The emitting industry does not impose any particular damage on that country in terms of its carbon dioxide emissions.

Rather, taking the EU cap on emissions as a given, an additional emission in a particular member state should be regarded as a negative externality on the other member states (because it forces them to reduce their own emissions, or accept that their common objective will be missed)[6].

The basic reason why ETS revenues should be allocated to the EU is that the corresponding policy is fundamentally a common policy. Emission reduction objectives are set at EU level in view of common Nationally Determined Contributions put forward within the framework of the United Nations Framework Convention on Climate Change conferences.

Whoever auctions off an allowance, wherever the corresponding emission takes place in the EU, and wherever the resulting good or service is consumed, the impact on common policy outcomes is the same. In this respect, proceeds from the sale of ETS allowances are not that different from customs duties.

Moreover, the bulk of emission allowances destined for auction are allocated to member states on the basis of historical emissions (and a remainder is allocated on distributional grounds to the least wealthy member states). Revisions are infrequent.

Emission allowances therefore have the character of a rent that is granted to member states. The higher the ETS carbon price, the more member states benefit from it. In this set-up, a decision by the EU to increase the pace of decarbonisation and to reduce the overall volume of emissions may paradoxically result in a higher rent, especially for carbon-intensive countries.

These are strong reasons why, on pure economic grounds, proceeds from the auctioning of emission permits should be allocated to the EU and not to any particular member state. Obviously, a shift from national resources to an EU resource would raise significant transitional and distributional difficulties.

Like any 'Pigouvian' resource, ETS revenues will fall as the EU moves towards reaching its CO_2 neutrality objective. But for a time of transition, which is likely to last until 2050 at least, the ETS will continue to generate revenue (Box 1).

Moreover, proceeds from the auctioning of permits are likely to exceed the 2019 level of €15 billion in the years to come. This is because although global emissions volumes are set to decline, three factors will gradually contribute to increasing revenues:

- The increase in the carbon price;
- The substitution of free allowances by auctioned allowances;
- The broadening of the ETS scope to sectors currently not covered.

Simulations indicate that total ETS revenues in the 30 years to 2050 would amount to about €300 billion in an exceedingly conservative scenario (Box 1, scenario 1: no price rise, no reduction in the share of free allowances, no widening of the scope of the ETS).

But the amount could approach €800 billion in a more realistic scenario (Box 1, scenario 3: price rise in line with revised carbon neutrality objective, reduction in the share of free allowances), or even €1.5 trillion, or €50 billion per year on average in a maximalist scenario (Box 1, scenario 5), in which most free allowances would be eliminated and most sectors would be covered. We are therefore speaking of a potentially significant resource.

Taxing carbon at the border

One of the challenges for carbon pricing policy in the EU is that it may generate leakage effects and undermine the competitiveness of producers of carbon-intensive goods.

Box 1. Potential future revenues from ETS auctions

The ETS is the world's largest carbon market. Being a cap-and-trade system, it sets a maximum level of emissions, a cap, and distributes emissions permits to firms that produce emissions. Each year's emission allowances are either given out for free (approximately 40 percent) or auctioned. The free allowances are meant to reduce the risk of carbon leakage (transfer of production to countries with laxer emission constraints) and to support new entrants. Currently, the cap is reduced yearly by approximately 48 million tonnes in accordance with the EU decarbonisation objective.

In addition, since 2019, the Market Stability Reserve (MSR) has operated, with the objective of reducing the surplus of allowances that are on the market as a consequence of past recessions, during which demand for emissions was below the cap. In 2020, the MSR reduced the total amount of allowances by a little below 400 million tonnes. The current recession is bound to increase further the surplus of allowances in circulation given the significant drop in industrial production, potentially justifying additional allowance- withdrawal measures.

In order to get a sense of the magnitude of the potential revenues from the ETS until 2050, we ran a couple back-of-the-envelope computations. In line with preliminary data on the decline in industrial activity due to the pandemic, we estimate that 50 percent of the allowances distributed or auctioned in 2020 will not be used, further increasing the total number of allowances in circulation. This implies that the MSR will reduce the number of new allowances by nearly 600 million in 2021.

In all scenarios, we assume that the EU will reach its 2050 carbon neutrality objective.

This means that the pace at which the ETS cap is reduced must increase compared to what is currently planned. Scenarios 1 through 4 assume the current scope of the ETS is maintained, with a linear reduction of allowances to achieve the 2050 objective of zero net carbon emissions.

In scenarios 1 through 3, the share of ETS allowances auctioned remains unchanged at approximately 60 percent. Essentially, this means that the EU does not pair the ETS efforts with a border adjustment mechanism meant to reduce the risk of carbon leakage. Scenario 1 considers the very conservative assumption that the price of carbon will remain more or less constant (at around €25/tCO_2) despite the decrease in supply. It can therefore be viewed as a lower bound for the generated revenue over the next decades. Scenario 2 takes the intermediary price trajectory put forth in the Commission's 2016 EU Reference Scenario (€25/tCO_2 in 2030, €50 in 2040 and €85 in 2050). Note that the predicted price for 2030 has already been attained.

In order to be in line with our assumption that the EU will achieve carbon neutrality in 2050, we consider a third price trajectory, which is put forth in the 'decarbonisation' scenario from the background material to the 2050 Long-Term Climate Strategy. In this scenario, the price reaches €50/tCO_2 in 2030, €100/tCO_2 in 2040 and €200/tCO_2 in 2050.

While scenario 3 maintains the assumption that only 57 percent of allowances are auctioned, scenario 4 assumes that the share of auctioned allowances reaches 80 percent. This decrease in the provision of free allowances to sectors heavily exposed to international competition could result from intensified international cooperation in the reduction of global emissions, or from the creation of a border adjustment mechanism aimed at reducing the risk of carbon leakage.

Finally, in scenario 5, the overall scope of the ETS is broadened in order to include 50 percent of agricultural and transportation sectors. Again, we consider a linear decrease in the amount of emissions. For the sake of simplicity, we assume for scenarios 4 and 5 that the corresponding changes in the functioning and the scope of the ETS take place already in 2021.

Estimates for the revenue generated in 2021-2050 range from €329 billion to €1.5 trillion, depending on the scope and the projected price of carbon.

Table 1. ETS revenue scenarios

<table>
<tr><th></th><th>Share of auctioned allowances</th><th>Scope of ETS</th><th>CO_2 price trajectory</th><th>Generated revenue (€ billions, 2021-2050)</th></tr>
<tr><td>Scenario 1</td><td></td><td rowspan="3">Current scope</td><td>Constant price (€25/tCO_2)</td><td>329</td></tr>
<tr><td>Scenario 2</td><td>57%</td><td>2016 EU Reference Scenario</td><td>442</td></tr>
<tr><td>Scenario 3</td><td></td><td rowspan="3">'Decarbonisation' price scenario</td><td>789</td></tr>
<tr><td>Scenario 4</td><td></td><td rowspan="2">Expansion of the ETS to cover 50% of the agricultural and the transport sectors</td><td>1120</td></tr>
<tr><td>Scenario 5</td><td>80%</td><td>1500</td></tr>
</table>

Source: Bruegel.

Despite the Market Stability Reserve, ETS revenues would potentially remain volatile. The EU could possibly introduce a floor price to stabilise the carbon price, thereby providing a cleaner signal to economic agents and contributing to a steadier income stream.

If the carbon price increases in the EU but not in other countries, European companies will lose domestic and foreign market shares and production could simply be relocated to other countries. This would be counterproductive in terms of both climate protection and economic development in Europe.

A carbon border adjustment (CBA) mechanism has been proposed as a way of preventing this leakage effect. In principle, a CBA could be applied symmetrically to imports and exports. Its logic is similar to that of border adjustment in the case of indirect taxes such as value added tax and excise taxes.

Goods imported to the EU would pay a charge which reflects their 'carbon content' – that is the CO_2 emissions generated by their production (the charge being calculated so that the overall price on these CO_2 emissions is the same as the EU carbon price).

Symmetrically, goods exported to other countries would get a rebate reflecting the difference between the carbon price paid for their production in Europe and the carbon price in the destination market. A symmetric CBA would level the playing field between producers facing different carbon prices in the countries where their production is located[7].

If a CBA was indeed symmetric, it would by itself generate little revenue – in fact its revenue could even be negative if the carbon content of exported products was higher than that of imports[8].

A CBA applied to both imports and exports would also imply that the EU would not be able to effectively steer the carbon content of domestic economic activity. This is because carbon pricing with full and symmetric border adjustment implies that the carbon price effectively applies to domestic consumption but not domestic production.

Production in the EU could remain highly carbon-intensive as a long as the produced goods are exported. Whether this would be perceived as compatible with climate protection objectives is doubtful. In fact, the EU intends to introduce a CBA which is restricted to imposing a levy on carbon-intensive imports (European Commission, 2020). This has consequences for leakage and competitiveness issues.

The competitive disadvantages of EU production relative to production outside the EU would be neutralised for sales in EU markets, but not in markets outside the EU. Nevertheless, a properly designed CBA restricted to imports could make a significant contribution to reducing carbon leakage (Box 2).

Digital taxation

The European Council conclusions of July 2020 mentioned the possibility of an own resource based on a digital levy. In recent years the implications of digitisation for taxation have attracted great attention in the international tax policy debate. The view is widespread that current principles for allocating taxing rights are not suitable for companies with digital business models, and that as a consequence these companies do not pay taxes where they should and as they should.

"Transforming ETS auction revenues into an EU resource and reducing GNI contributions would entail significant reallocation from carbon-intensive to less carbon-intensive member states"

There is also growing evidence suggesting that existing international tax rules allow multinational companies to avoid taxes (Beer *et al*, 2020; Tørsløv *et al*, 2020; Fuest *et al*, 2020). This gives them a competitive advantage over national firms and brings into question the fairness of the overall tax system.

This applies in particular to corporate income taxation. Companies pay corporate income tax in the countries where they are legally resident or have a physical presence. Digital business models allow firms to operate in foreign countries without a physical presence and without legal residence.

Current rules about the international distribution of taxing rights do not foresee that firms pay corporate income taxes in countries where they sell their products. Income taxes are paid primarily in the countries in which corporations reside and where they develop and produce their products and services.

According to these rules, it is appropriate that United States digital companies that develop and produce their services in the US do not pay corporate income taxes in Europe. In the same way, European automotive companies that export cars to the US should pay corporate income taxes primarily in Europe, not in the US.

The matter is being discussed at global and EU levels. The tax challenges of the digital economy are being addressed within the framework of the Organisation for Economic Co-operation and Development's base erosion and profit shifting (BEPS) action programme.

The aim is to agree on new principles for the allocation of taxing rights: a country in which digital companies operate without significant physical presence (a market jurisdiction) would be granted taxing rights on the basis of a formula determining that a share of the profits of multinational firms are to be taxed in the market countries where the company sells its products.

Digital companies would not be subject to specific taxation, but the new international architecture would be designed in such a way that part of the corresponding tax base would be reallocated to the jurisdictions were users of digital services are located (OECD Pillar I proposal).

Box 2. The design of a carbon border adjustment mechanism

Setting up CBA raises a number of questions about the design of the import levy. Policymakers need to decide which goods are covered, which emissions will be taken into account, how the CBA levy is calculated, whether carbon pricing in the countries of origin should be recognised and, last but not least, how it can be designed comply with WTO rules (Horn and Sapir, 2019; Droege and Fischer, 2020).

A pragmatic approach would be to restrict the CBA to the sectors with the greatest leakage risk. In a pilot phase it could start, for instance, with only steel, chemicals and cement. Taking into account carbon prices and the carbon content of production in origin countries would be appropriate, given the objective of preventing leakage, but raises technical difficulties, unless these countries themselves rely on an ETS or an explicit carbon tax.

It would also be necessary to avoid conflicts with WTO principles. There are many ways to achieve this, which differ in terms of their administrative complexity and the incentives they create for foreign producers and governments to reduce CO_2 emissions[9]. At a more general level, WTO compatibility requires that a CBA does not discriminate against foreign producers relative to domestic producers. This suggests that free emissions allowances for domestic companies in sectors with a high risk of carbon leakage would have to be phased out if a CBA is introduced.

Some commentators hope that a CBA would raise significant revenue, and that taxes would be paid by foreign producers rather than European consumers. This is in part an illusion. Revenues will depend on a number of factors (the coverage of the CBA, the extent to which carbon pricing in the origin countries is taken into account, the way in which the carbon content of products is calculated, how carbon intensity of foreign production develops over time and of course how the EU carbon price develops). The range of possible outcomes in terms of revenue is broad. Krenek *et al* (2019), who used a simulation model and considered CBA scenarios with broad coverage, found that, for 2023, revenue raised could be between €36 billion and €83 billion[10]. These are very large numbers. For instance, in 2018, customs duties on all products imported to the EU amounted to €25 billion. Whether the trading partners would accept new import duties of this magnitude is questionable. A realistic CBA system would probably collect significantly less revenue[11].

Finally, the fact that revenues from a CBA would be paid by importers does not mean that the burden of taxation would fall on foreign producers exclusively. Domestic consumers would face higher prices on imported final goods and, indirectly, on domestic final goods with a high content of carbon-rich imports. These higher prices would be the channel through which information on the carbon content of imported goods would reach the European consumer, and because of which consumers would tilt their consumption baskets in favour of less carbon-intensive domestic goods.

Overall, we do not primarily regard a carbon border adjustment mechanism as a direct source of revenue, but rather as a device intended to limit competitive distortions in a world in which countries do not move at the same speed towards decarbonisation. The primary objective in fighting global emissions is that the largest possible number of countries should strive to decarbonise their economies, in which case the CBA would raise no revenue whatsoever.

A CBA would however have major indirect revenue effects, through its impact on the ETS. From 2013 to 2020, only 46 percent of ETS allowances were sold or auctioned; the rest were allocated for free[12]. For 2021 to 2030, the goal is to increase the share of auctioned allowances to 57 percent, still far from complete coverage. Free allocations are essentially destined for carbon-intensive sectors facing international competition. In the presence of a CBA, they could be further reduced or possibly even abolished. As a result more revenue would be raised from the ETS.

At EU level, the matter is being addressed within the framework of long-standing discussions on the Common Consolidated Corporate Tax Base (CCCTB). The European Commission tabled in 2011, and relaunched in 2016, a proposal for a Common Consolidated Corporate Tax Base that would redefine the tax base for multinational companies operating in the EU.

In 2018, the Commission proposed a reform of international corporate tax rules, which would introduce the concept of 'digital presence', so that companies with digital business models would be liable to corporate income taxation even in countries where they operate without a physical presence.

But since such a reform requires international coordination and would only be feasible in the medium term, the European Commission also proposed as an interim solution the introduction of a tax on the revenue from the provision of certain digital services (European Commission, 2018b).

This digital services tax would define a set of services provided through the internet and would require companies above a certain size to pay a 3 percent tax on revenues from delivering these services.

In the Commission proposal there would be no deductibility of costs, so that this is a tax on turnover, not on corporate income. A possible alternative also considered would be a tax on net income (after deducting a series of costs incurred in the market jurisdiction). Some EU countries have already introduced, or have announced that they intend to introduce, digital services taxes.

Given the complexity of the issue and remaining differences of views, discussions at OECD level will certainly require additional time before an agreement can be reached. In the meantime, the EU could still move ahead with its digital services tax.

To provide a significant and lasting contribution to EU own resources, such a tax would however have to overcome a number of challenges:

- The aim of discussions held at the OECD is to reach agreement on a structural response that would redefine the allocation of taxing rights to national jurisdictions.

  Many EU member states are adamant that a structural solution of this sort should be put in place and the EU itself has been consistently supportive. But such a solution would allocate revenues to individual member states and deprive the EU of a new own resource;

- The Commission proposal for a Common Consolidated Corporate Tax Base that would redefine the tax base for multinational companies operating in the EU does not envision allocating taxing rights to the EU, but rather to redefine them for member states;

- For these reasons, a digital services tax could only serve as a temporary fix for an interim period. Moreover, its unilateral introduction would be contentious, especially with the US, as it would be seen (and actually is seen) as targeting US digital giants. The US government has already announced that it would respond with tariffs on EU exports to the US;

- Finally, revenues would be limited. The Commission estimated in 2018 that a 3 percent tax on the gross turnover of companies with total revenues above €750 million and EU revenues above €50 million would yield €5 billion annually[13].

  The actual resource flow could be significantly lower, if the tax is levied on net turnover or if other amendments are introduced to accommodate US concerns. In its factsheet of May 2020, the Commission actually lowered its estimate to €1.3 billion annually[14].

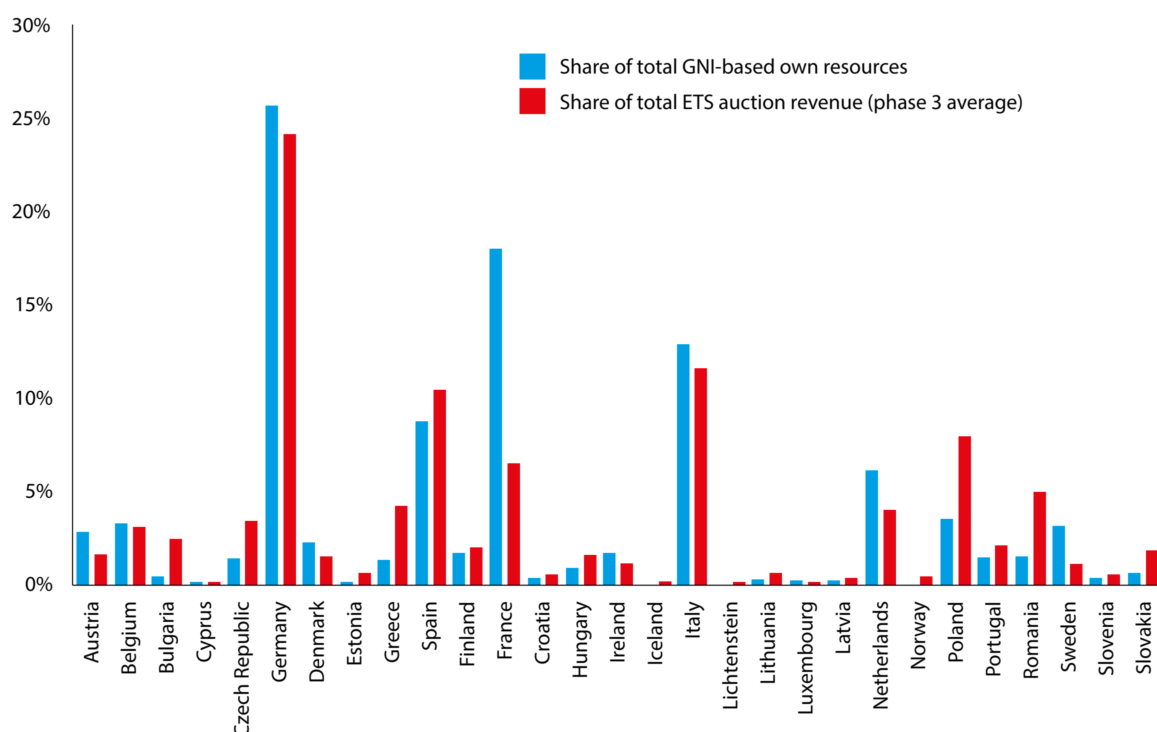
Given this, while we see the potential role of the digital services tax initiative in the context of the complex international discussions on a new allocation of taxing rights, and while in view of the single market, we certainly regard a European digital services tax as preferable to a collection of national digital services taxes, we doubt it could provide a structural response to the tax optimisation problem. We think that for the reform of the EU own resources system, the focus should be on other instruments.

Other resources

Several other revenue sources have been mentioned as potential candidates for new own resources. In addition to the ETS, a carbon border adjustment mechanism and a digital levy, the July European Council conclusions mentioned the possibility of a financial transactions tax and confirmed a charge on non-recycled plastic[15].

Irrespective of the ongoing discussion on the potential merits and drawbacks of a financial transactions tax from the point of views of efficiency and fairness, the following should be

Figure 2. Comparative distribution of GNI contributions and ETS revenues



Source: Bruegel based on European Commission.

borne in mind when assessing the suitability of the FTT as an EU own resources:

- The European Council explicitly mentions the FTT as a potential resource not for the next MFF but for the subsequent one;

- Proposals for an FTT are supported only by a minority of member states, at least at this stage. An enhanced cooperation procedure was initiated in 2013 by 11 member states. The latest proposal, on the initiative of Germany, is supported by 10 member states in total.

  A variable-geometry approach would not be suitable for financing the EU budget, unless countries that do not introduce the FTT make other contributions to the EU budget as compensation. In addition to being complex, this solution would require the negotiation of an ad-hoc agreement;

- According to the Scientific Council of the German Ministry of Finance, expected revenue would be around €3.5 billion annually (Wissenschaftlicher Beirat beim BMF, 2020). This would be a comparatively small contribution to the financing of the recovery plan.

  Estimates of the revenue from an FTT are furthermore highly uncertain, since market structure and the volume of transactions can evolve significantly in response to taxation;

- One could argue that the FTT would be particularly suited as a basis for own resources because financial transactions related to activities in the EU as a whole are concentrated in leading financial hubs including Luxemburg, Paris and Frankfurt.

  However, one should bear in mind in this context that regional specialization is a general feature of the European internal market. This fact alone is not sufficient as an argument that revenues should not be ascribed to the country where they are collected.

However, if EU member states were to introduce an FTT at European level for use as an EU own resource, it would certainly be preferable to a multitude of national and uncoordinated FTTs, primarily because national FTTs may distort financial transactions within the EU.

The tax on non-recycled plastic, meanwhile, will be payable as of the start of 2021. In the light of the criteria discussed earlier, this tax is not particularly suitable as an own resource. To start with, the revenue can easily be (and actually is) ascribed to the member state where it is collected. Moreover, the main purpose of the tax is to reduce plastic litter, which is primarily a local environmental issue.

The European Commission fact sheet of May also mentions a levy *"on operations of companies that draw huge benefits from the EU single market"* and mentions revenue of €10 billion annually. Although this would be significant, we regard this levy as a rather uncertain temporary substitute for the common consolidated taxation of corporate profits, and doubt it could be a stable resource for the EU finances.

Finally, the introduction of a Common Consolidated Corporate Tax Base is primarily a project to reduce compliance costs for businesses operating across borders. Currently they have to deal with 27 different national tax systems, which is a burden in particular for small and medium-sized firms.

In principle these benefits are independent of the use of this tax as a base for an own resource. In some ways, ascribing the revenue to the member states would be easier under a CCCTB than it is now, because the CCCTB would use formula apportionment rather than separate accounting, which is arguably more vulnerable to tax planning.

In any case, using corporate taxes as a basis for own resources would require agreement on a common tax base. Past attempts to achieve this have not been successful; progress will take time.

Moreover, in the area of corporate taxation, an additional and more fundamental consideration is that the flexibility to react to current developments, such as changes in international tax competition or economic crises and booms, is important. The question is whether this flexibility is compatible with the principle of unanimity in EU-level decision- making in taxation.

Given this, corporate taxes could be a future candidate for own resources, but only after reforming the institutional framework and creating more room for decision making by majority.

An ETS-based own resource: implementation issues

The conclusion from the previous analysis is that revenue from the ETS is not the only, but by far the most promising candidate for new EU own resource and for financing the recovery plan. The potential introduction of an ETS-based own resource however raises two related issues:

- How the potential revenue stream would compare to the debt repayment stream resulting from the legacy of the Next Generation EU recovery plan;

- How the transition from a member-state resource to an EU own resource should be managed.

On the basis of the July 2020 European Council conclusions, the EU is expected to borrow up to €390 billion (in 2018 prices) from 2021 to 2026 and to pay down the corresponding debt by 2058 at the latest.

Given that, at the time of writing, the euro yield curve for AAA-rated bond is entirely in negative territory, interest costs can be ignored in a first approximation at least.

The simulation presented earlier indicates that expected revenues from ETS auctions from 2021 to 2050 period would represent an amount commensurate, and possibly in

significant excess of the future debt repayments. In particular, the criteria for introducing new resources, which we regard as realistic, would lead to a cumulated €789 billion revenue stream over the next 30 years.

In 2018 the European Commission proposed to use 20 percent of current ETS revenues as an EU own resource. Under the current practice of allocating more than 40 percent of the ETS allowances for free, the revenue raised would be small – the European Commission (2018a) estimated that between €1.2 billion and €3 billion annually would be raised for the EU budget, which is very little.

Even if the share of free allocations was reduced significantly, the effect on the overall composition of own resources would be small. But these are conservative estimates. Moreover, as we have explained, there are no convincing reasons why ETS allowance ownership and, as a consequence, auction revenues should be allocated to member states as they currently are. This suggests that the greatest part of the revenues could be used to fund the EU budget.

Transforming auction revenues into an EU resource and reducing GNI contributions accordingly would however entail significant reallocation from carbon-intensive to less carbon-intensive member states (Figure 2).

There are sound justifications for such a reallocation: if the distribution of emission allowances across member states is kept constant, the rise in the ETS carbon price would result in major gains for some member states: for example, under the realistic scenario, ETS auction revenues for 2030 would amount to 0.51 percent of GNI for Bulgaria and 0.35 percent in Slovakia.

Anyhow, redistributing existing rights would be opposed by some member states, so at minimum, a transition period would be necessary. Offsetting excessive short-term redistributive effects could furthermore require side payments, possibly through rebates or other compensation measures.

But we see no reason why the EU should depart from the principle that revenue from ETS auctions has the character of a genuine own resource.

A way to avoid an abrupt shift in revenue from member states to the EU would be to transfer to the EU the whole proceeds from the auctioning of emission allowances, and to redirect annually to member states notional auctioned emissions revenues, computed as their share of 2019 auctioned emissions multiplied by the annual EU linear reduction factor and corrected for the impact of the MSR.

These notional auctions would be valued at a price capped at the level of the 2019 ETS carbon price. This would preserve countries' initial revenues while making room for a gradual increase in the revenue accruing to the EU.

Such a formula would amount to a recognition that countries are entitled to a grandfathering right and should not be deprived of it. In addition, side payments from and to member states could be introduced to correct for any undesirable distributional effects from the swapping of the GNI-based resource for ETS revenue.

In practical terms therefore, proceeds from ETS auctions would become a new EU resource. Compensatory mechanisms would be introduced to ensure a gradual transition and address distributional concerns.

Box 3. A proposal for phasing out national ETS revenues

Over the next decades and especially with the prospect of rapidly increasing prices, the ETS has the potential to generate large revenues. The reallocation of these revenues from member states to the EU's own resources would have to take place progressively. We argue that this 'phasing-out' could be engineered simply by capping the amount that member states receive for each auctioned allowance at the current carbon price of €25. All additional revenue, resulting from increases in the number of auctioned allowances compared to 2018, or from the increase of prices above €25, would constitute an EU own resource.

Given the overall trend of decreasing allowances (in order to achieve the 2050 carbon neutrality objectives), this would amount to a reduction in the revenues received by member states from the ETS. The reduction in national revenues would be compensated for by cutting the amount of GNI-based own contributions to the EU budget. Possibly, direct offsetting transfers would be added to limit the distributional effects arising from the member states' unequal revenues from ETS auctions.

Note that the initial increase in revenues for member states results from the expected intervention of the MSR in order to reduce the amount of allowances in circulation. As a result, the number of auctioned allowances will likely increase in the next few years, despite a tightening of the overall cap.

In addition, the excess revenue would enable the complete repayment of the €390 billion that the EU is expected to borrow between 2021 and 2026. The total €789 billion generated by the ETS under scenario 3 could be used as follows:

- €329 billion would accrue to member states as grandfather rights;
- €390 billion would be allocated to the repayment of the Next Generation EU debt;
- A remaining €70 billion would finance EU budgetary expenditures, enabling a corresponding reduction in member states' GNI-based contributions, or could be used to offset transfers to certain member states.

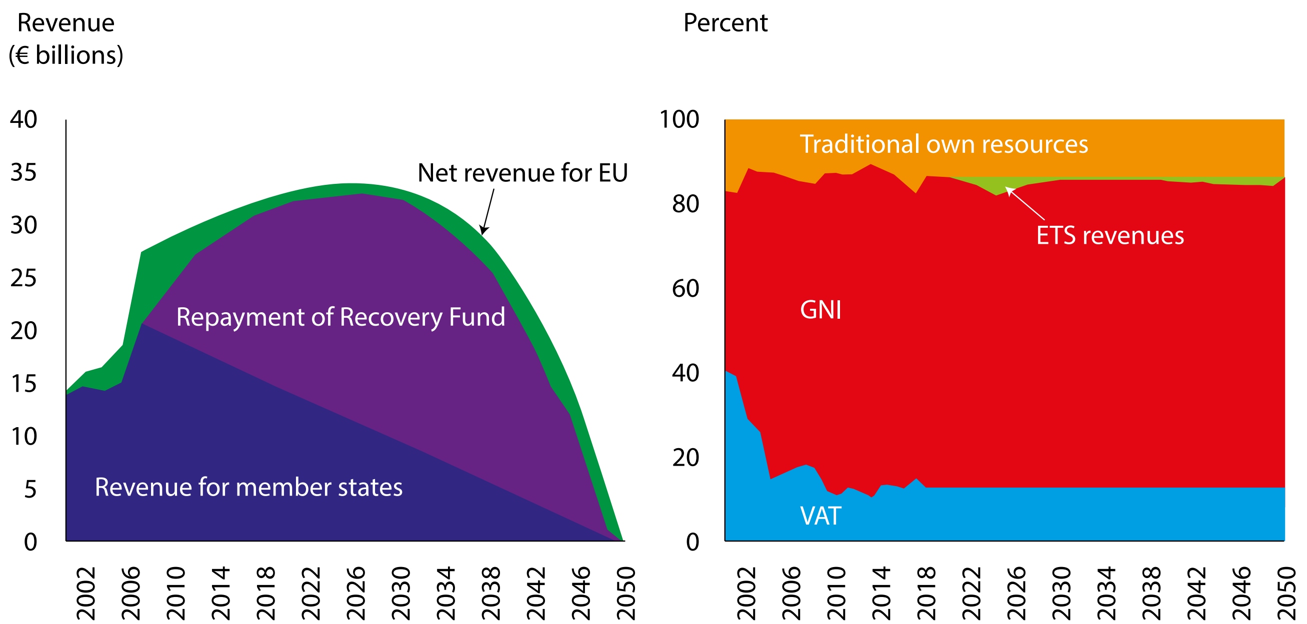
As EU budget expenditures would remain unchanged while GNI contributions would be swapped for ETS revenues, our proposal would be budgetarily neutral. Currently, member states must devote at least 50 percent of ETS revenues to energy and climate-related objectives[16].

This commitment could easily be translated into pluriannual targets for specific climate-related spending, which would be financed by member states out of the diminution of the GNI contributions.

Simulations suggest that in a realistic scenario, ETS revenues could be sufficient to repay the Next Generation EU debt, finance the gradual phasing-out of national ETS auction revenues, and contribute to the financing of the EU budgetary expenditures, or to the financing of offsetting transfers to certain member states (Box 3 and Figure 3).

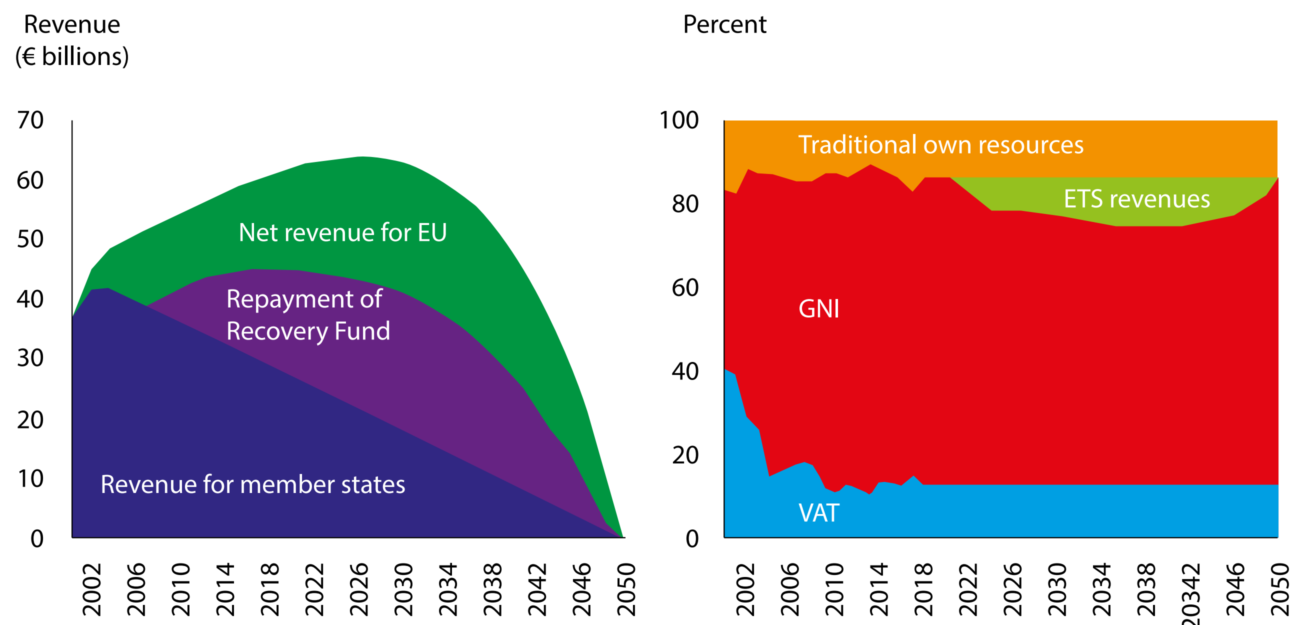
In a scenario in which 80 percent of allowances would be auctioned off and half of the transport and agriculture sectors would be covered by the ETS, the net revenue to the EU would

Figure 3. Possible allocation of ETS revenues and structure of EU resources (net of debt repayment) under scenario 3



Source: Bruegel.

Figure 4. Possible allocation of ETS revenues and structure of EU resources (net of debt repayment) under scenario 5



Source: Bruegel.

be more significant and would, at least temporarily, result in a change in the structure of the financing of the EU budget (Figure 4).

We do not consider a case in which the EU would miss its decarbonisation objectives and would continue auctioning off allowances beyond 2050, but in this case, obviously, corresponding resources would have a more lasting character.

Conclusions

At its July 2020 meeting, the European Council took the unprecedented decision to launch a new and ambitious recovery programme. This decision, taken in response to what the heads of state and government rightly regarded as a major threat to the future of the EU, has the character of a game-changer.

Pre-existing discussions about the financing of the EU budget must be reassessed in the light of this bold move. This applies in particular to the old discussion on EU own resources. Our conclusion, after having examined the potential candidates for new EU own resources, is that only a swapping of GNI contributions for ETS revenues would match the spirit and magnitude of the decision taken in July.

Other options may have merits and can be considered, but only the revenue from the ETS has both the economic characteristics of a genuine EU own resource and the potential to deliver quantitatively meaningful sums. Allocating it to the financing of the budget would be a strong signal of the EU commitment to climate neutrality.

Moreover, maintaining the status quo while accelerating the pace of decarbonisation would give rise to unjustifiable rents. The time to decide is now.

The distributional issues raised by our solution are significant, but solvable. We have offered one solution, but other options are possible. Under realistic assumptions, ETS revenues in the EU are set to increase significantly before they ultimately decline and dwindle.

The corresponding revenue stream will most likely be sufficient to pay back the Next Generation EU debt, finance grandfather rights, and leave sufficient amounts for offsetting transfers to member states unfavourably affected by the swap. The EU has solved harder problems. It can tackle this one. ■

Endnotes

1. See the Council decision of 21 April 1970 [https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:31970D0243&from=EN] on the replacement of financial contributions from member states by the Communities' own resources.

2. HLGOR (2016), p.23. A different view is taken, for instance, by the German Advisory Board to the Federal Ministry of Finance (2016). This report emphasises the advantages of GNI contributions in terms of transparency and subsidiarity and argues that a significant part of current EU spending is indeed redistributive without creating much added value, so that net balances do have a certain relevance.

3. See our report to ministers Le Maire and Scholz on EU public goods (Fuest and Pisani-Ferry, 2019).

4. "The Union will over the coming years work towards reforming the own resources system and introduce new own resources. As a first step, a new own resource based on non-recycled plastic waste will be introduced and apply as of 1 January 2021. As a basis for additional own resources, the Commission will put forward in the first semester of 2021 proposals on a carbon border adjustment mechanism and on a digital levy, with a view to their introduction at the latest by 1 January 2023. In the same spirit, the Commission will put forward a proposal on a revised ETS scheme, possibly extending it to aviation and maritime. Finally, the Union will, in the course of the next MFF, work towards the introduction of other own resources, which may include a Financial Transaction Tax. The proceeds of the new own resources introduced after 2021 will be used for early repayment of NGEU borrowing." Conclusions of the Special meeting of the European Council [https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf] (17, 18, 19, 20 and 21 July 2020).

5. European Council Conclusions [https://www.consilium.europa.eu/media/41768/12-euco-final-conclusions-en.pdf], December 2019.

6. Since 2013 the cap on emissions has been set at EU level rather than at the level of each member state.

7. See, for instance, Krenek et al (2019), p. 10.

8. There is an impact of CBA on ETS revenues that needs to be taken into account.

9. For a detailed discussion see Droege and Fischer (2020), p. 32-33.

10. See Krenek et al (2019), p. 19. These numbers refer to a scenario group which plausibly assumes that carbon intensity continues to decline over time.

11. The numbers in Krenek et al (2019) are based on the assumption of broad coverage and a carbon price of €69. It is more likely that, at least in the short to medium term, coverage will be more limited, and the EU carbon price may take more time before it reaches €69.

12. Source: European Environmental Agency, https://www.eea.europa.eu/data-and-maps/dashboards/emissions- trading-viewer-1.

13. See https://ec.europa.eu/commission/presscorner/detail/en/MEMO_18_2141.

14. See https://ec.europa.eu/info/sites/info/files/factsheet_3_en.pdf.

15. Strictly speaking it is a charge member states would pay from their national budgets.

16. See EU Directive 2003/87/EC.

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The challenge of climate finance

Alexander Lehmann is a Non-Resident Fellow at Bruegel, and Mark Plant is Co-Director of Development Finance and Senior Policy Fellow at CGD

Addressing the challenge of financing the low-carbon transition will require substantial investment in the European Union and in emerging and developing economies.

Sustainable finance frameworks have proliferated in advanced and emerging markets but fragmentation of financial flows due to different classification systems and standards for green financial instruments is a real risk. Ensuring consistency should be a core agenda for the new International Platform on Sustainable Finance (IPSF).

Estimates suggest that about 70% of the infrastructure investment needed for the low-carbon transition will have to be deployed in the emerging markets and developing economies (EMDEs). Countries' updated nationally determined commitments, which are due ahead of the COP-26 UN climate summit in 2021, will underline the scale of this challenge.

They are bound to highlight considerable financing shortfalls as resources from national budgets and development funds will be scarce in the aftermath of the current recession.

The substantial investment needs compare with as yet scarce flows of private climate finance. Such flows are at present dominated by development institutions, and by private funds blended with such concessional financing, though the target of an annual $100 billion transfer from the advanced to the developing countries for green investment is not yet met.

A new paper[1] finds that private sources account for just over half of total climate finance mobilized globally, as national development banks and multilateral development banks dominate this area.

Of the total climate finance for projects in non-OECD countries only between one fifth and one third was derived from cross-border flows, and only 15% of the total global volume of climate finance flowed from OECD to non-OECD countries.

The implementation of the EU's 2018 sustainable finance agenda laid the basis for the financial sector to fund a greater share of the low-carbon transition and to reflect climate risks in prudential regulation. EU rule-making has already produced a number of results: a taxonomy of economic activities aligned with climate policy which will be in effect from 2021; a proposal for a green bond standard; and a regulation on investment funds that can be labelled as supporting the low-carbon transition.

The revision of the non-financial reporting directive, which would align the EU with the recommendations of the G20 Task Force on Climate Related Disclosures (TCFD), remains under discussion.

What has perhaps been overlooked is that EU regulation will have profound implications for international flows of climate finance, on which developing countries in particular will depend to finance their investments in climate mitigation and adaptation.

EU investors could be an important source of private climate finance, as they already account for over 40% of the total portfolio debt outstanding in emerging and developing economies. But regulation now needs to be reviewed to facilitate cross-border flows of climate finance.

A potential forum for coordination

The new International Platform on Sustainable Finance, launched by the EU in 2019, could be one venue for coordination of climate finance regulation. In this forum, the EU partners with thirteen other economies, including key emerging markets such as China, India and Indonesia.

Potentially, and given that key jurisdictions are already represented, this group could play a central role in converging on common standards, for instance on disclosure or on the green labels used for financial instruments.

To date, the agenda for this group remains somewhat vague and has been limited to sharing and comparing national initiatives. Members of the group are likely to voice strong and disparate national interests, which will have to be reconciled:

- Among the five non-EU high-income countries in the group there will be interest in developing a local green financial market place (eg. Singapore) and green banking standards (Switzerland); or in adopting strong environmental, social and governance (ESG) standards

If the new IPSF is to become a real forum for common rule-making, the EU will need to contend with concerns in other jurisdictions that the EU framework has reinforced the fragmentation of global climate finance

by portfolio investors (as promoted by Norway's large sovereign wealth fund).

- Two emerging markets participating in the Platform, China and Indonesia, are assessed[2] as already having mature sustainable finance frameworks, including sustainability reporting requirements, green loan definitions, and a local green bond framework, similar to the provisions adopted in the EU.

- Several participants have developed independent green bond standards. China, based on its own taxonomy, accounts for more than two thirds of the green bonds issued by emerging markets in recent years. Indonesia and Chile have issued substantial amounts of sovereign green bonds in international markets in recent years.

- The group also includes smaller lower middle-income countries, including Kenya, Morocco and Senegal, where issuance of green financial products is developing within very limited local capital markets.

Despite its size — this group accounts for roughly half of global greenhouse gas emissions and about 45% of global

GDP – the EU platform could become more representative. In early 2020, 25 countries were working on sustainable finance roadmaps, which may produce similar classification systems and standards for green capital market products.

These countries include key emerging markets such as Brazil, Nigeria, Mexico or Vietnam, who should be encouraged to join the EU platform.

Crucially, the United Kingdom will now diverge from the EU in a separate regulatory regime, and should also be brought into the Platform.

The EU's role

From the EU's perspective, an overriding ambition within the IPSF should be that a high standard for sustainable finance is protected internationally. This should address the risk that 'greenwashing' by individual issuers, fund managers or jurisdictions – the misleading disclosure to prospective investors or conduct by the borrower that deviates from initial commitments – could undermine the entire sustainable finance asset class.

Asset managers, in both retail and professional markets, should be offered transparent green finance products of a

consistent high standard. This could replicate the success of other EU capital market standards, such as for retail investment funds.

At the same time, the EU should ensure that financial products that fund EMDE projects based on local taxonomies remain eligible for green funds structured by EU asset managers or for loan refinancing, making it consistent with open international markets for climate finance.

For instance, an EU registered fund marketed as low-carbon or 'Paris-aligned' under the new EU benchmark regulation should be able to include green bonds from a wide range of developing country issuers.

This should require that such issuers comply with EU standards for borrower disclosure and verification by accredited firms of the non-financial aspects in bond documentation, such as the use of proceeds.

Principles for coordinating cross-border flows

Coordination between central banks on supervision and stress testing are well under way within the Network for Greening the Financial System.

In the EMDEs, and in particular in lower middle-income countries, national banking systems will remain the dominant source of climate finance, as the rapid expansion of capital markets or attracting international investors focused on ESG criteria are not realistic.

Agreement on green banking principles, which remain much more diffuse than in the capital markets space, are therefore essential. The IPSF could spearhead this initiative, thereby addressing the current lack of international coordination.

The IPSF could focus on three areas in particular:

- EU investors and cross-border banks will be bound by taxonomies that define green activities eligible for designated green financial instruments, and possibly for incentives.

  A comparison[3] of such classification systems shows that the EU system is by far the most complex, setting metrics and thresholds for 70 climate mitigation activities and 68 adaptation activities. The Chinese system, by contrast, is much more general and does not include specific screening criteria.

  Developing countries will include local investment priorities (especially in climate adaptation) and local environmental issues, such as pollution abatement. There should be common design principles for taxonomies, though which activities benefit from incentives may well differ across jurisdictions.

- Disclosure by financial firms and their large corporate clients is a foundation for offering financial instruments with added green qualities.

  Implementation of the recommendations of the G20 Task Force on Climate Related Disclosure (TCFD) is weak among mid-sized companies and in emerging markets, as requirements for the measurement of environmental impact are rare in the real sector.

  The EU directive on non-financial reporting, which is currently under revision, should define practical environmental reporting templates. The EU could support capacity building in large emerging markets implementing similar standards, and open the proposed EU repository for ESG data to private sector issuers of green bonds.

- Standards for the origination and labelling of green financial products. Given this greater transparency, green financial products can emerge that are readily recognised by investors.

  The future green bond standard, and the now adopted low-carbon benchmarks for investment funds are the key necessary pieces of EU legislation. Even though the market for green bonds and ESG funds has grown rapidly on the basis of private sector standards, regulation will need to address incentives for 'greenwashing' by debt issuers and investment firms.

  Emerging market issuers and fund managers should have the option of meeting the future EU green bond standard, including by working with locally accredited verifying agents, which are recognised by the EU as subject to equivalent supervision.

If the new IPSF is to become a real forum for common rule-making, the EU will need to contend with concerns in other jurisdictions that the EU framework has reinforced the fragmentation of global climate finance.

Many of the partner countries represented in the platform and other key emerging markets now have credible sustainable finance frameworks of their own.

As the climate challenge is global, realigning financial flows also requires a coordinated response. The new EU forum should be as inclusive as possible. ■

Endnotes

1. https://www.cgdev.org/publication/private-sector-climate-finance-after-crisis
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3. http://documents1.worldbank.org/curated/en/953011593410423487/pdf/Developing-a-National-Green-Taxonomy-A-World-Bank-Guide.pdf

The Malta Business Aviation Association (MBAA) aims to promote excellence and professionalism amongst our Members to enable them to deliver best-in-class safety and operational efficiency, whilst representing their interests at all levels in Malta and consequently Europe. The MBAA will strive to ensure recognition of business aviation as a vital part of the aviation infrastructure and the Maltese economy.

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The start of this new decade has brought some of the biggest changes and challenges the world has ever seen. As we navigate this new reality, individuals and families are faced with decisions and choices that will affect their legacy and investing abroad is an effective way to protect personal portfolios. World Commerce Review interviews Luigi Wewege, the Senior Vice President and Head of Private Banking at Caye International Bank, who are based in the tropical paradise of Belize, an investment location that is well worth taking into consideration

The global economy is challenging at the moment. How would you describe the current local economic climate and prospects for the future in Belize?

With agriculture and tourism, the key elements of Belize's economy, the country has a core strength to help it bounce back from global economic instability. The land, the ocean and the reef are sustainable natural resources that will help with its recovery.

For someone who is thinking of starting a new business or relocating an existing one, what significant advantages does Belize offers as a business location?

Belize offers major tax advantages for foreign investors. In fact, since the International Business Companies Act of 1990, IBCs set up for non-residents of Belize have the ability to operate tax-free. The country also offers ease of doing business. Foreign entities can start businesses in Belize with very similar requirements to local residents.

Bank accounts can even be opened remotely. Belize's location in the Americas offers easy travel from the US, and access to export markets. While it is hard to quantify, one of the biggest benefits of operating in Belize is a more relaxed way of doing business, which leads to a much more personable approach.

Asset protection is vitally important to the investor. What are the pros and cons of investing abroad in general, and Belize in particular?

Investing abroad is a great way to assure privacy and asset protection. This is a unique way of diversifying a portfolio to be separate from the economic, political and other varying conditions in your home country.

I would say that one of the Belize pros is that the country has a stable currency tied to the US dollar. Belize's banks have legally required liquidity rates of at least 24 per cent, which are very high, roughly four to five times those required in the United States for their domestic banks. Also, for those who choose to live near their investments, the country is a tropical paradise. As for the cons, Belize is still considered to be in the 'third world' category, with coinciding risk and lack of infrastructure in certain areas of the country.

How is the Belize government encouraging foreign investment and foreign business ownership? What are the short- and long-term goals?

Belize encourages foreign investment to help rapidly increase GDP and develop local capabilities. This includes joint venture and partnership investments, as well as 100 per cent foreign ownership.

The government offers incentive programmes in numerous investment sectors, including agriculture, agro-processing, aquaculture, fisheries, logistics, light manufacturing, offshore outsourcing, sustainable energy, and tourism-related industries.

There are also duty-free Export Processing Zones with multi-decade income-tax holidays. In addition, Belize is a member of CARICOM, enhancing many opportunities for trade within the Caribbean region.

Short-term goals for the country's government include the need to continue efforts to rein in public debt and narrow the fiscal deficit. A longer-term goal for the country is economic diversification, since Belize's economy relies primarily on tourism and exports of marine products, citrus, sugar and bananas.

Tourism is one of the biggest growth areas for Belize's economy, meaning on-going demand for new businesses and existing business growth catering to visitors.

Do you see Caye International Bank having a role in the economic growth of Belize?

Yes, absolutely. As mentioned, tourism is one of the biggest growth areas for Belize's economy, meaning on-going demand for new businesses and existing business growth catering to visitors.

Caye International Bank plays a role in providing not just a place for offshore savings accounts, but also a source of funds for investment in these and other opportunities for supporting the country's economy.

The biggest impact is through local financing of everything from commercial mortgages to residential construction loans, which allow foreigners to participate in the economic growth of Belize.

How can foreign ownership of businesses and property benefit the citizens of Belize?

Foreign investment can make a big difference. Belize is a very small country, so investment from external resources is quite important.

The Belize government particularly encourages investment in export-oriented businesses and the associated increased employment and development of local technological capacity.

Real estate is one of the prime movers of economic development in Belize. While some of the development comes from domestic sources, a significant amount results from actions of international investors and buyers.

It's not just people who plan on retiring to the country eventually who help drive the real estate market growth, but also business owners who seek to purchase and develop properties.

How skilled and knowledgeable is the local workforce? Do you think the foreign business owner or investor has a role to play in the development of these capabilities?

English is the official language of Belize, providing a leg-up for the local workforce in basic skills and development capability, especially in interacting with international customers. More than 70 percent of the country's population has completed secondary education.

Today, while agriculture and tourism make up almost half of the industry in Belize, roughly the other half of the labour force is in services and professional occupations. Also, women are now entering the workforce in greater numbers, thus creating a need for more jobs to be created by the government, so as to keep unemployment down.

Foreign business owners and investors create demand for more workers, often with specific skills not taught through the Belizean education system. Fortunately, most of the developmental training needed is available somewhere in the world and can fairly easily be used to upskill the local workforce through online education modules.

We hear a lot about digitalisation and fintech. What steps has Belize taken to adapt to the digital age vis-à-vis digital infrastructure?

Yes, Belize has not just developed a strategy, but also taken action in the last decade to expand its digital capabilities, partly through the implementation of state-of-the-art fibre-optic connectivity.

Belize's prime minister, Dean Barrow, says that this will give the country core data infrastructure on a par with London, New York, Singapore or even Seoul. This expansion of broadband penetration has enabled an increased rate of GDP growth for the country over the last decade.

There is an increasing concern about the prevalence of money laundering in the global economy. What steps is Belize taking to address these concerns?

Sadly, criminal operations and money laundering are potential concerns in every country of the world. That is why the US passed the Money Laundering Control Act of 1986 and continues extensive activities to prevent money

Offshore bank accounts are some of the most powerful financial tools that you can employ for managing personal wealth with safety, privacy and asset protection

laundering on an on-going basis. Belize passed its own Money Laundering and Terrorism (Prevention) Act in 2008, with additional legislation in 2013 and 2018.

Belize has completed a national risk assessment and is preparing a national plan of action to address those risks. The March 2020 *International Narcotics Control Strategy Report on Money Laundering* from the US State Department recognises Belize's rigorous anti-money laundering legal, policy and regulatory framework and praises the strong political will to combat money laundering. Thus, I believe progress has been made and the right things are happening to minimise risk.

What does Caye International Bank offer as a partner for foreign investors in Belize?

Offshore bank accounts are some of the most powerful financial tools that you can employ for managing personal wealth with safety, privacy and asset protection.

One of the great things about having offshore savings, checking and investment accounts is that they remain relatively untouched by whatever is happening within your home jurisdiction, such as a local recession or a political shift.

Assets held in offshore accounts aren't subject to judgments awarded by domestic courts. With offshore bank accounts in place, people can have a foundation for getting back on their feet after personal or national setbacks.

Diversification can also allow investors to engage in currency exchanges, which makes it possible to build more wealth. Caye International Bank fulfils the dual role of facilitating this investment and acting as caretaker.

You have a long history of involvement with the financial services industry, particularly with regards to developments in technology. What does the financial sector need from its senior managers to adapt to the quickly-changing financial environment?

Leaders who are able to develop an adaptive vision and implement responsive systems to meet clients' new needs are the ones who will be the most successful.

There are two ways of dealing with rapid change. One way is through reactive protectionism. This is often through trying to stop the bleeding when change is forced upon you. This can be done by tweaking costs here and there to still be in the black for each quarterly budget.

The other is a nimbler, proactive approach. Knowing that most changes are not short-term, recognise that the first inkling of any change is a signal of potential opportunity.

Leaders who are able to develop an adaptive vision and implement responsive systems to meet clients' new needs are the ones who will be the most successful. Often the big breakthrough successes come from leveraging disruptive change.

It's important to note that getting to this point also requires helping employees develop skills to deal with this rapid change and as always, communicating 'what' and 'why' is critical to success. ■

EXECUTIVE PROFILE

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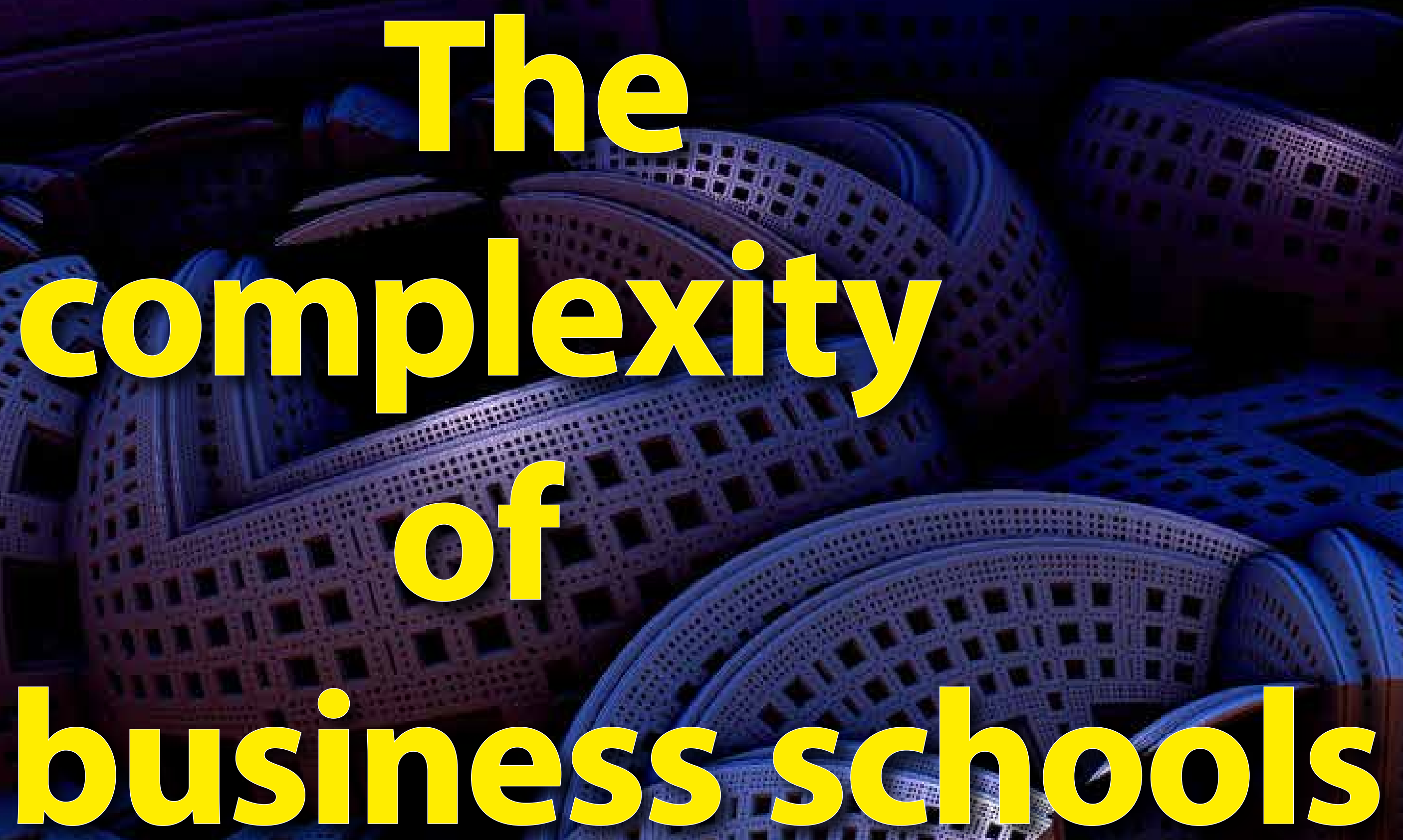
The complexity of business schools



Kai Peters and Howard Thomas wonder how long business schools can survive the growing complexity of their industry

Increasingly, universities and, relatedly, business schools have become more complex and complicated – with multiple activities, multiple locations and multiple audiences. For example, state-wide higher-education systems exist across many US states including California, Texas, Virginia and Illinois while complex groupings of different Catholic clerical orders run universities around the world.

Complexity is increasing even at the more mundane level of individual universities and business schools, be they integrated or stand-alone institutions. Many work across multiple sites bridging urban and suburban campuses.

Add to this feeder/foundation-year activities and expanding online education often delivered in conjunction with for-profit partners, international campuses, academic partnerships and validation activities.

For another layer of complexity, consider the different products and services ranging from "business to consumer" items such as undergraduate and post-graduate pre-experience degrees, to post-experience programmes, part-time programmes for working professionals through to business to business executive education where corporate learning and development managers purchase education on behalf of their staff.

Lastly, scale these elements up to a global level. At last count, there are close to 200 countries in the world. Many of these countries are involved in international student mobility either as exporters or importers of students. In some, direct student recruitment is possible. In most, educational agents intermediate between the university and a school.

One can thus view the managerial challenges of these more complex institutions as a three-dimensional Rubik's cube with one axis representing products, another location and third markets. Defining the suitable strategies and structures for institutional success, alas, is neither simple nor as well developed as it ought to be.

Recent trends

In some cases, institutions were brought together through mergers policies instigated by local, regional or national governments. In France particularly, funding that had previously been provided by local Chambers of Commerce for business schools began to dry up leading to new constellations of multi-location institutions. French schools KEDGE and SKEMA are examples of these top-down driven mergers.

In other cases, mergers have occurred in more of a "mergers and acquisitions" manner to achieve critical mass. Reading University's acquisition of Henley Business School in the UK, Arizona State's acquisition of Thunderbird in the US and Hult's UK acquisition of Ashridge are all examples along these lines. Invariably there was an acquirer and the target.

Taking place mostly (but not exclusively) in the private sector and often (but not solely) originating from US or UK for-profit educational groups, a 'buy and build' strategy has been pursued. In some cases, the portfolio of schools has become significant and invariably the range of institutions acquired

Business subjects are lucrative cash cows for universities and are often used by the central university administration to fund more 'proper' university activities. One could be significantly harsher here but at last glance university presidents seem to view business schools more as funding sources than as legitimate university departments

have covered a wide range of subjects and degree levels. A particularly interesting example to watch is EM Lyon in France, which not only has multiple locations but has also recently been acquired by a consortium of investment firms.

A number of individual institutions have expanded to the point where they have become small groups in and of themselves, having added suburban or urban campuses, international locations, and online activities. One of the authors' own institution, Coventry University, now has five sites in the UK, three internationally, extensive online provision and a range of partnership arrangements.

This article thus has two goals. The first sets out to investigate what these market changes mean for increasingly complex business school internal management. The second is to reflect on what these developments mean for business school associations and accreditation activities.

Management consequences

There are two key effects of this scaling-up that deserve attention. The first is definitely paramount for many university-based business schools. It is simply that business schools are often no longer, if they ever were, masters of their own destinies. Decision making on scaling-up locations and activities largely happen beyond their control.

New initiatives such as branch campuses are almost always determined at a central university level, especially given that they often offer multiple subject area courses. Mergers and acquisitions are also centrally run.

Over time, this leads to business school activities in a variety of different forms and locations. A business school will no doubt have opinions and may well be consulted but generally does not have the final say on the original initiatives or management later on.

Similarly, how support services are organised across a university is also not in the gift of the business school. There is presently a noticeable trend in many universities to centralise a whole host of services in the name of efficiency and of avoiding duplication or divergence.

One clear factor, at least in the UK, is the increasingly stifling set of regulations faced by all institutions. There is thus a marked increase in centralised marketing, student recruitment and admissions; of centralised student advisory services, and of careers planning in addition to centralised registry, legal, financial, IT and HR services.

There clearly are benefits here but also down-sides in relation to the increased adoption of command/control, micro-management styles of management at university level.

Business subjects are lucrative cash cows for universities and are often used by the central university administration to fund more 'proper' university activities. One could be significantly harsher here but at last glance university presidents seem to view business schools more as funding sources than as legitimate university departments.

For both the university-based and multi-location stand-alone business schools, the increased complexity has also, of course, led to multiple challenges on the more prosaic educational delivery tasks such as developing common educational goals among the various campuses; paying attention to the different groups of students and faculty members; ensuring that the curriculum, the standards of admissions and progression and professional support services are of high quality and consistent; and lastly, ensuring that geographically separated staff members can meet each other and collaborate rather than compete.

Sometimes these challenges have been met and group cohesion is successful; often the consequence is a group of largely autonomous entities related fundamentally but in name only.

Higher education institutions increasingly ought to reflect on how corporations, professional service firms or for that matter hotel groups or supermarkets manage local responsiveness with overall cohesion. This is a theme we are investigating at the moment. We live too much in a business school/university bubble.

Consequences for accreditation

While business school accreditation bodies nobly seek to be aware of trends and developments in the 'sector' insufficient attention has been paid to the role of the university and the expansion of institutions into complex groups.

Increasingly, there is thus a need to expand the lens from a focus on the business school to a focus on the business school within its national context and especially within the context of a broader university.

Presently, many accreditation guidelines assume business school have autonomy and control, which is simply not the case in many institutions. This can lead to ambiguity and disconnect between the 'rules' and the realities.

In touring the business school landscape extensively, one comes across myriad institutions where business subjects are taught in other locations and often in other faculties where faculty members are not 'academically qualified, research-active and fully participating'.

Validation and franchising arrangements, which exist widely in the UK and many Australian and Canadian universities, mean that parent university degrees are awarded to distant students. These partnerships tend to generate modest incomes but can also be seen as a positive form of sharing expertise and thus worthy activities. It depends on one's lens.

It must also be noted here that expecting business schools in developing markets like West Africa or Indonesia to adhere to Western expectations is unrealistic. Whether they are the other side of a validation agreement or independent, they rarely have the history or resource base to engage in a research paradigm that is considered 'proper' in developed nations.

In terms of the control of the marketing, student recruitment and management mechanisms, there are also issues where rules and realities diverge. Clearly, ring-fencing the business school and suggesting it should control all of these means of production is laudable as the business school would

almost always prefer this, but it is unrealistic in the context of university vice-chancellors and presidents who make the rules.

Making sense of all of this and passing appropriate accreditation judgement is, therefore, a significant challenge but one that must continuously be tackled.

Conclusion

If, from a management side, we posit that structure should follow a strategy and we also add some insights from professional service firms then we can examine these issues more dispassionately.

If we look at income versus cost control on one axis and centralisation versus decentralisation on another, we can draw some conclusions in those realms.

For example, on the income-generating side, overall brand cohesion and undergraduate recruitment in markets where there is a centralised governmental student application system make sense as centralised collective university or group endeavours.

At the time of writing (late March 2020) it seems certain that the present COVID-19 pandemic will lead to further closures and mergers. Additionally, the pandemic will stimulate important changes in learning approaches, involving perhaps even more novel mixes of on-line and F2F teaching.

Specific 'product' marketing, especially at the post-graduate level, requires specific knowledge about the subject, local conditions, student recruitment markets, and the ecosystem of actors and employers in that field. This, we suggest, is best left to individual business schools and faculties.

On the cost management side, professional services are generally best structured in a centralised manner for cohesion and fairness across an institution. We would nevertheless posit that physical centralisation creates 'them and us' conflicts and that embedding professional services within business schools and faculties while drawing them together as a collective is preferable.

Matrix management is clearly unavoidable here but there are ways to make it work. In all cases, open and honest discussions rather than turf wars are necessary.

On the accreditation side, it is hard to suggest a simple solution but it is clear to us that increased competition leading to financial difficulties for some institutions will continue the trend towards increased size, complexity and ambiguity in those institutions that survive.

By way of focus, since 1984 the US Department of Education's Federal Student Aid database notes that over 12,000 branch campuses and complete institutions have been shut because they were unsustainable.

This will improve the quality, effectiveness and reach of responsible management education. It will also alter the business model of business schools significantly.

For anyone in higher education, these developments ought to sharpen the mind and suggests to us in any case that we all need to balance the rights bestowed through academic freedom with the responsibilities for competent and prudent management and an acknowledgement of the challenges we face.

From both a management and an accreditation perspective, we believe that an open dialogue about these realities for business schools should be ongoing and very worthwhile.

Business schools need to continue to prove their academic legitimacy and value in order not to descend into a permanent cash cow status.

There will be no simple answers but awareness and collaborative acknowledgement of these realities is paramount. ■

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Even in our COVID moment, sustainability remains a focus for business aviation

Ed Bolen is President and CEO the National Business Aviation Association (NBAA)

Among the many effects from the COVID-19 pandemic has been a noticeable reduction in greenhouse gas (GHG) emissions around the globe, as demand across all modes of air, land and sea transport dwindled earlier this year, due to international travel restrictions and regional lockdown efforts stemming from the virus.

That hasn't gone unnoticed, and as travel demand inevitably rebounds, this places even greater emphasis on the need for sustainability in the worldwide aviation sector, including the business aviation community.

Although global business aviation operations represent but a tiny fraction of overall CO_2 emissions, the industry is committed to exploring ways to further improve on this figure.

The National Business Aviation Association (NBAA) is working proactively along several fronts to reduce our industry's already-low carbon footprint in the years ahead. One of the most promising and accessible means to lower carbon emissions from business aircraft is sustainable aviation fuel (SAF).

This cleaner-burning alternative to straight petroleum-based Jet-A can be derived from any number of renewable feedstocks and offers the potential for reducing net lifecycle carbon emissions by at least 50%, while still meeting ASTM D1655 standards.

SAF is not new to our industry; in fact, it was recognized back in 2009 as a pathway toward our industry's shared Business Aviation Commitment on Climate Change (BACCC), an aggressive program led by the International Business Aviation Council (IBAC) and endorsed by business aviation associations worldwide.

While we've made inroads to promote use of SAF in the decade since, it's clear more work needs to be done, particularly in the

changed post-COVID environment. This extends not only to increasing availability and access to SAF, but also educating operators and other industry stakeholders about the fuel's many benefits and its use as a true drop-in replacement for conventional Jet-A.

Earlier this year, the Business Aviation Coalition for Sustainable Aviation Fuel (SAF Coalition) released its updated and enhanced SAF 'Guide' for our industry. Titled *Fueling the Future*[1], the revised guide serves as an educational and informational resource for leaders in our industry about the practicalities of SAF development, industry adoption, and pending expansion of supply and use.

In addition to coverage by aviation media, the guide's rollout was also covered by sustainability focused news outlets including *Biofuels Digest*, *Renewable Energy Magazine* and others, perhaps offering the audience for those outlets a new look at business aviation.

The news was also picked up by DC-policymaker-focused outlets. For example, Politico noted that *"[b]ackers of sustainable aviation fuel are pushing to spread their message across the industry, ahead of a summit next month."* The website also highlighted the recent addition of the Commercial Aviation Alternative Fuels Initiative to the SAF Coalition.

Highlighting SAF's many benefits

The revised SAF guide builds upon other recent efforts by NBAA and other members of the SAF Coalition to build enthusiasm and support for sustainable fuels. In January 2019, our association helped stage at California's Van Nuys Airport the first business aviation demonstration of the viability and benefits of SAF. The event, attended by media representatives and civic leaders alike, was a major industry milestone.

"Once again, business aviation is demonstrating its important part in the global sustainability conversation"

The Van Nuys showcase was followed four months later by a similar SAF event, held for the first time in Europe at Farnborough Airport. Just days later, 23 SAF-fuelled business aircraft flew from several US and European airports to Geneva for the European Business Aviation Convention & Exhibition (EBACE).

At the 2019 Business Aviation Convention & Exhibition (NBAA-BACE) in Las Vegas, NV, every refuelling turbine aircraft on display departed from Henderson Executive Airport powered by SAF. Earlier this year, SAF was also made available at Zurich Airport for those traveling to the World Economic Forum in Davos, further emphasizing how sustainability is increasingly intertwined with the global economic community.

At that time, plans were also underway for a new Business Aviation Global Sustainability Summit, to be held in March 2020 in Washington, DC, to accelerate the industry's development, availability and use of the fuels. Unfortunately, COVID-19 forced the Summit's postponement, in line with the pandemic's impact on nearly all other events – including the 2020 edition of NBAA-BACE, where SAF was once again to be front-and-centre.

Even as so much in our world has changed, however, the importance of SAF as a key path toward ever greater

sustainability across business aviation has not changed – and that's a message that needs to be shared, now more than ever.

A virtual event, a vital dialogue

As this issue of *World Commerce Review* was published, business aviation stakeholders around the world convened online for a first-of-its-kind Virtual Business Aviation Global Sustainability Summit.

Taking place September 14-15, the summit brought together industry leaders, executives and representatives from business aviation OEMs and a host of other noted experts and officials to discuss pathways to accelerate the market for SAF.

Topics addressed at the virtual summit included:

- Why SAF is important to business aviation, how the fuel performs with business jets and SAF's role in the BACCC.
- Perspectives from international fuel providers on near-term supply strategies and SAF transaction models
- Regulator and stakeholder insights on long-term solutions to encourage SAF adoption
- Expediting access when operators say, *"I want my SAF!"*

The ongoing COVID-19 crisis did not negate the need for business aviation to highlight its continued work toward sustainability; in fact, this moment has only made the issue an increasingly critical priority, as we all ask how we may reduce emissions further and faster.

Once again, business aviation is demonstrating its important part in the global sustainability conversation. We expect the Virtual Business Aviation Global Sustainability Summit to be a watershed moment for our energetic, innovative and international industry and its work toward a greener, more sustainable future.

On behalf of NBAA, I encourage you to participate in this effort as well and examine how your operations may also utilize SAF to realize our shared goal of reduced carbon emissions. ■

1. *https://www.futureofsustainablefuel.com/*

Global value chain transformation to 2030

James Zhan is the Director, Richard Bolwijn is Head of Investment Research, Bruno Casella is Senior Economist, and Amelia U Santos-Paulino is Chief of Investment Issues Section, all at UNCTAD's Division on Investment and Enterprise

Global value chains will undergo a drastic transformation in the decade ahead. The change will be driven by a push for greater supply chain resilience due to COVID-19, which adds to existing pressures from the technology revolution, growing economic nationalism, and the sustainability imperative.

Based on UNCTAD's *World Investment Report 2020*, this column argues that the global trade and investment landscape will be reshaped by the restructuring of global chains, build-up of new regional chains, and distributed manufacturing. While these will present daunting challenges, they will also offer ample opportunities for firms and states alike and will lead to a GVC-development paradigm shift.

Global value chains have been hit hard by the COVID-19 crisis. A number of recent columns in VoxEU warn against the risks of a reversal in economic globalisation and an unprecedented downsizing of the existing international production system (Bamber *et al*. 2020, Baldwin and Freeman 2020, Espitia *et al*. 2020, Kilic and Marin 2020, Mirodout 2020, Pitsch 2020, Seric and Winkler 2020, Stellinger *et al*. 2020).

However, COVID-19 is not the only gamechanger. The crisis caused by the pandemic arrives on top of existing mega-challenges to the system of international production arising from the new industrial revolution (Baldwin 2019, Bolwijn *et al*. 2019, Brun *et al*. 2019, Casella and Formenti 2018), growing economic nationalism (UNCTAD 2018, Blanchard 2019, Bellora and Fontagnè 2019, Zhan 2019) and the sustainability imperative (UNCTAD 2015, De Backer and Flaig 2017, Kolk *et al*. 2017, Zhan 2016). These challenges were already reaching an inflection point; the demand, supply and policy shocks caused by the pandemic are set to tip the scales.

UNCTAD's *World Investment Report 2020* (*WIR20*) not only takes stock of the impact of COVID-19 on FDI, but it also looks well beyond at the likely transformation of international production over the next decade 2021-2030. Recognising the uncertainty facing the global production system, it aims to provide a broad analytical framework to encompass the likely future trajectories and address the range of policy options for navigating the expected decade of transformation ahead.

2030 is also the horizon for the implementation of the United Nations Sustainable Development Goals. With less than a decade left and a huge investment gap to fill in developing countries, *WIR20* comes at a critical juncture, making it all the more important to evaluate the implications of the expected changes on the FDI landscape over the coming years (UNCTAD 2014, UNCTAD 2019, Zhan *et al*. 2020).

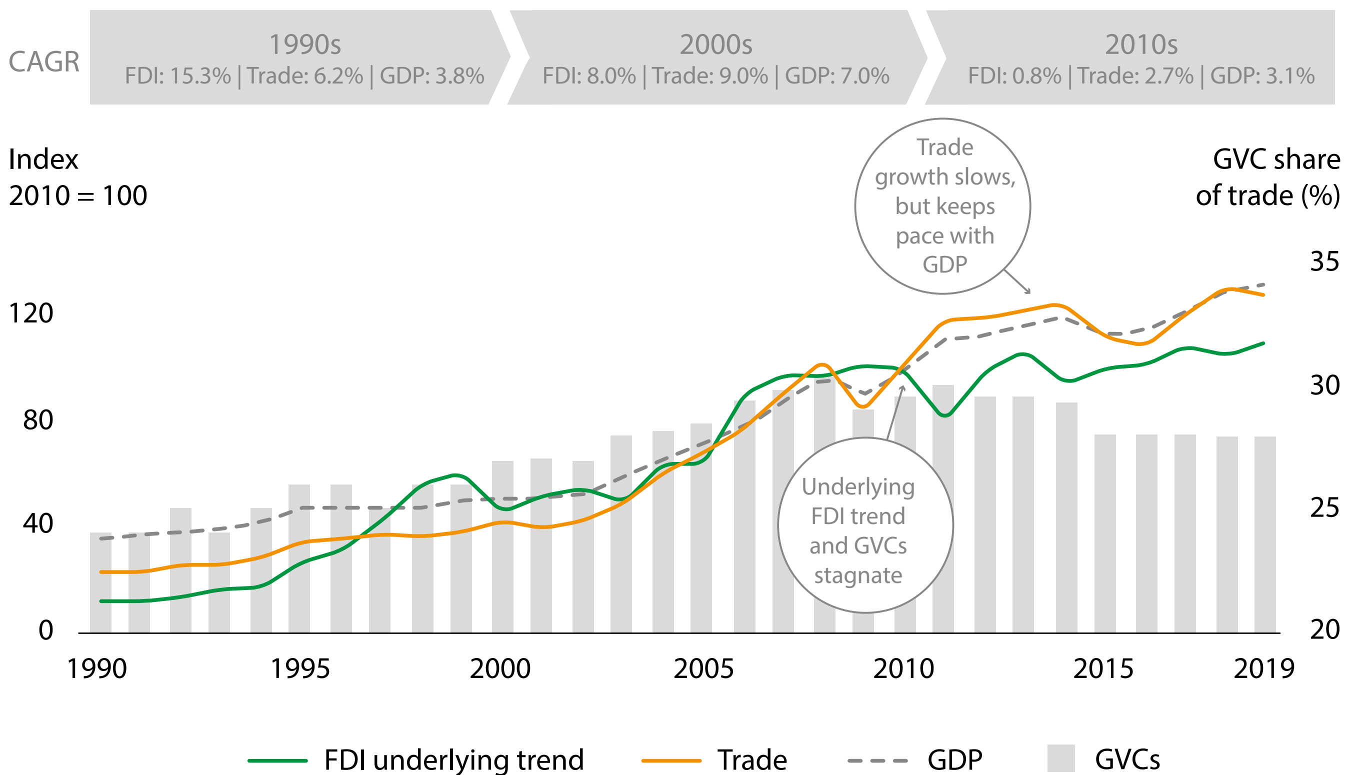
The pandemic magnifies existing challenges

The *World Investment Report* has monitored FDI and the activities of MNEs for 30 years, during which time international production saw two decades of rapid growth followed by a

Table 1. Megatrends shaping the future of international production

Megatrend	Trends
Technology/ New Industrial Revolution	• Advanced robotics and AI • Digitalisation in the supply chain • Additive manufacturing (3D printing)
Policy and economic governance	• More interventionism in national policies • More protectionism in trade and investment • More regional, bilateral and ad hoc economic cooperation
Sustainability	• Sustainability policies and regulations • Market-driven changes in products and processes • Physical supply chain impacts

Figure 1. The long-term trend of international production



Note: Trade is global exports of goods and services. GVC share of trade is proxied by the share of foreign value added in exports, based on the UNCTAD-Eora GVC database (Casella et al., 2019). The underlying FDI trend is an UNCTAD indicator capturing the long-term dynamics of FDI by netting out fluctuations driven by one-off transactions and volatile financial flows. (FDI, trade and GDP indexed, 2010 = 100; GVCs per cent)

decade of stagnation. Flows of cross-border investment in physical productive assets stopped growing in the 2010s, the growth of trade slowed down and GVC trade declined (figure 1).

The 2010s were only the quiet before the storm. The crisis caused by the COVID-19 pandemic arrives on top of existing challenges to the system of international production arising from the new industrial revolution (NIR), growing economic nationalism and the sustainability imperative (Table 1). The decade to 2030 is likely to prove a decade of transformation for international production.

Direction of the transformation in the post-pandemic era

WIR20 develops an analytical framework to assess the prospects for international production and GVCs. It shows that the megatrends listed above play out in three dimensions via four trajectories across five industry groupings.

Trade and investment trends unfold in three key dimensions of international production: the degree of fragmentation and the length of value chains (short to long), the geographical spread of value added (concentrated to distributed), and the governance choices of MNEs that determine the prevalence of arm's length trade vs FDI.

Several archetypical configurations can be identified covering industries that, together, account for the lion's share of global trade and investment. They include capital- and labour-intensive industries in the primary sector; high- and low-tech GVC-intensive industries; geographically dispersed processing and hub-and-spoke industries; and high and lower value-added services industries (Figure 2, upper section).

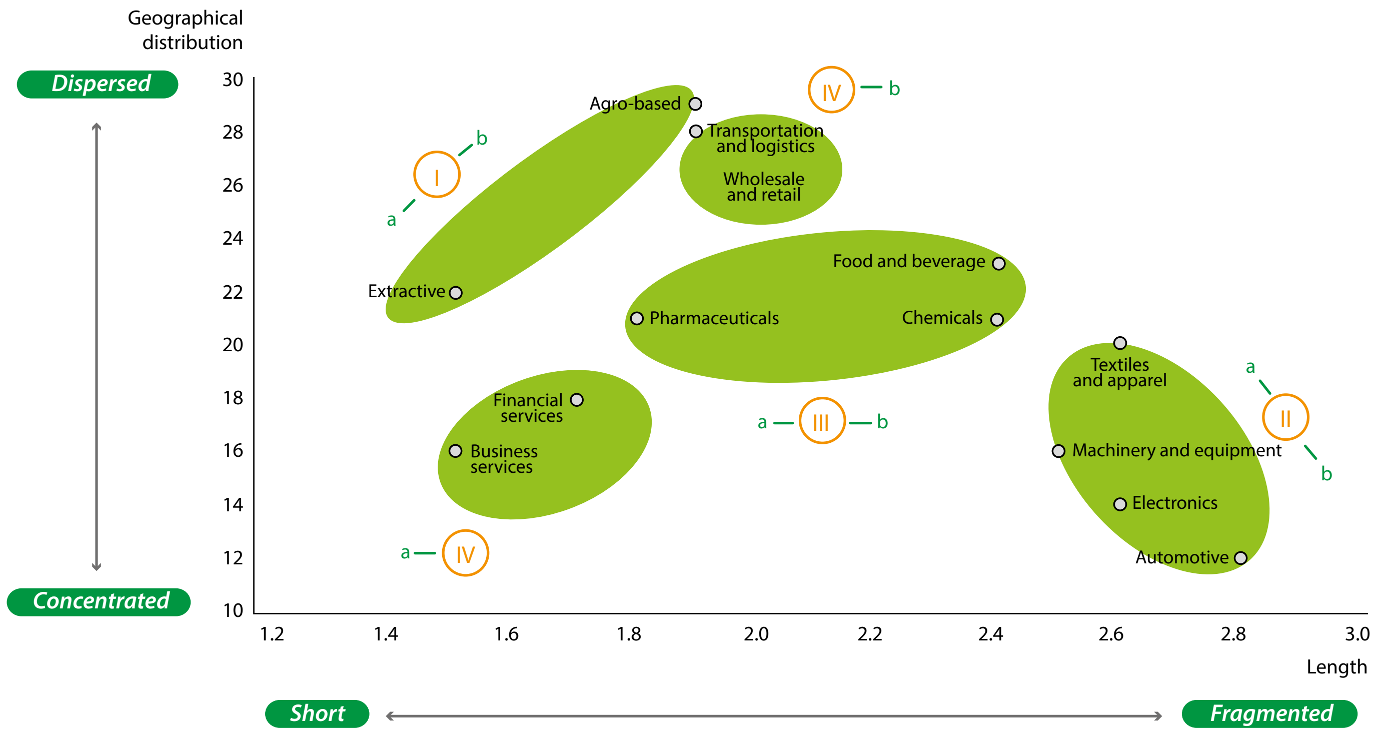
The effects of the technology, policy, and sustainability trends on international production are multifaceted. They are at times mutually reinforcing, and at others push in opposite directions; also playing out differently across industries and geographies.

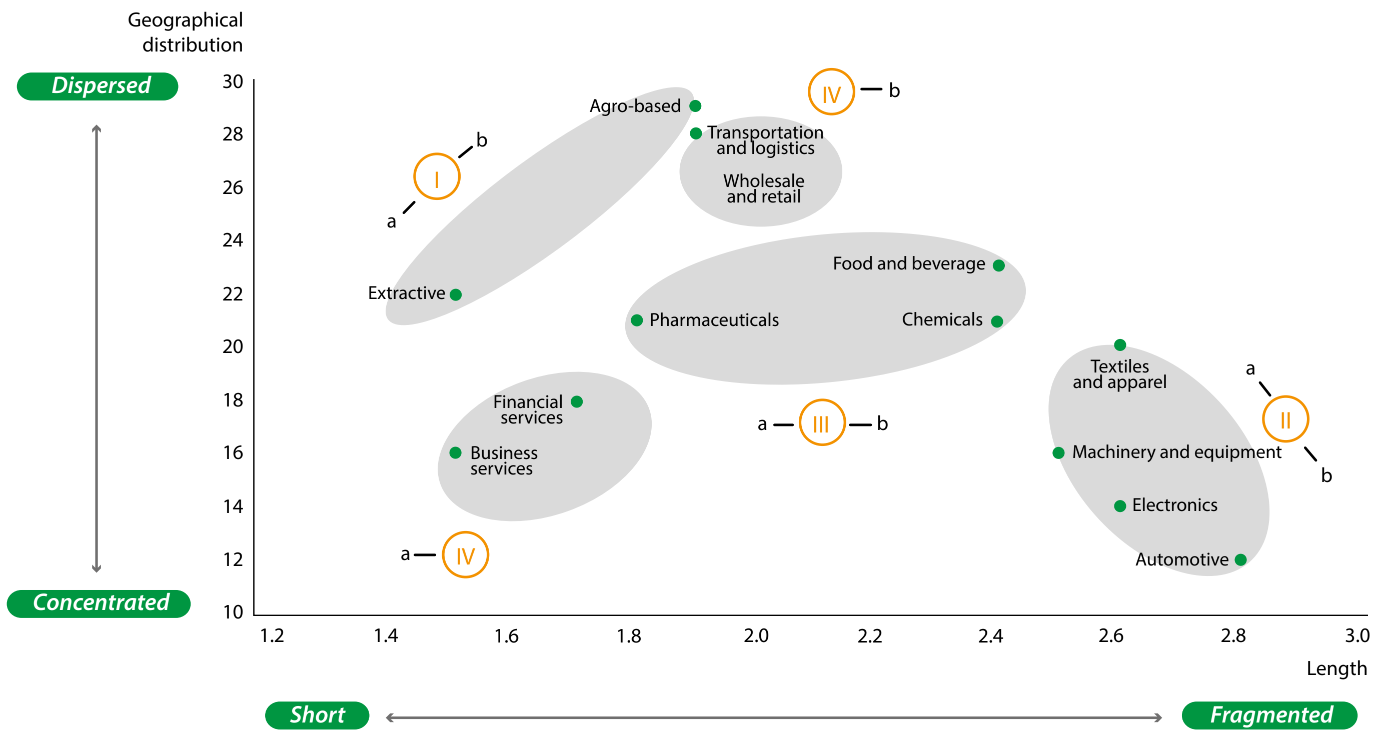
Depending on the starting point of individual industries – their archetypical international production configurations – they will tend to favour one of four trajectories (Figure 2, lower section).

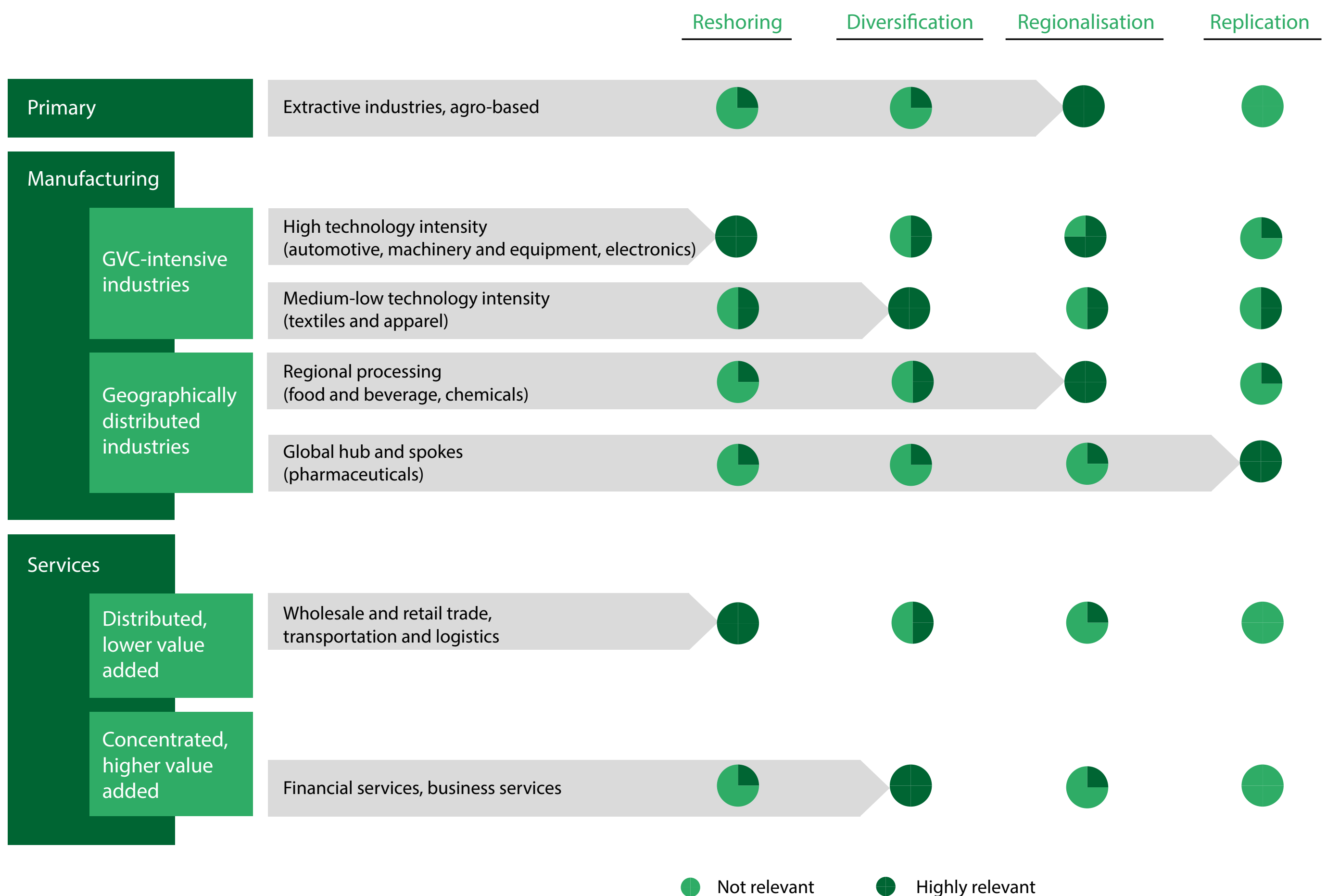
- *Reshoring* will lead to shorter, less fragmented value chains and a higher geographical concentration of value added. It will primarily affect higher-technology GVC-intensive industries. The implications of this trajectory include increased divestment and a shrinking pool of efficiency-seeking FDI.

- *Diversification* will lead to a wider distribution of economic activities. It will primarily affect services and GVC-intensive manufacturing industries. This trajectory will increase opportunities for new entrants (economies

Figure 2. Current configurations of international production and future trajectories







Note: Geographical distribution refers to the number of countries accounting for 80% of value added in a specific GVC industry, based on UNCTAD calculations using data from the Eora 26 database. Length is measured by the number of production stages in a specific GVC industry based on Miroudot and Nordström (2015).

and firms) to participate in GVCs, but its reliance on supply chain digitalization will cause those GVCs to be more loosely governed, platform-based and asset-light.

- *Regionalisation* will reduce the physical length but not the fragmentation of supply chains. The geographical distribution of value added will increase. This trajectory will affect regional processing industries, some GVC-intensive industries and even the primary sector.

- *Replication* will lead to shorter value chains and a rebundling of production stages. It will lead to more geographically distributed activities, but more concentrated value added. It will be especially relevant for hub-and-spoke and regional processing industries.

Although the different trajectories show that the expected transformation of international production is not unidirectional, the overall direction of travel points towards:

- Shorter and less fragmented value chains

- More concentrated value added

- More platform-driven and asset-light value chain governance

- A shift from global to regional and sub-regional value chains

- Downward pressure on global efficiency-seeking FDI in favour of regional market-seeking FDI

- Downward pressure on global trade in intermediate goods, less on trade in final products

- A shift in some industries from large-scale investment to smaller-scale distributed manufacturing

- Continued growth and fragmentation in services value chains

- Resilience and national security concerns as key drivers of GVC diversification

- A shift from GVC-investment to cross-border investment

“Policymakers need to prepare for the challenges arising due the transformation of international production and be ready to capture the opportunities”

in infrastructure, domestic services and in the green and blue economies driven by the sustainability imperative

Policy implications: towards a new GVC-development path

Policymakers need to prepare for the challenges arising due the transformation of international production and be ready to capture the opportunities.

Challenges include increased divestment, relocations, investment diversion, and a shrinking pool of efficiency-seeking investment implying tougher competition for FDI. Value capture in GVCs and development based on vertical specialisation will become more difficult.

Industrial infrastructure built for a world of GVCs will see diminishing returns. Changes in locational determinants of investment will often negatively affect the chances of developing countries to attract MNE operations.

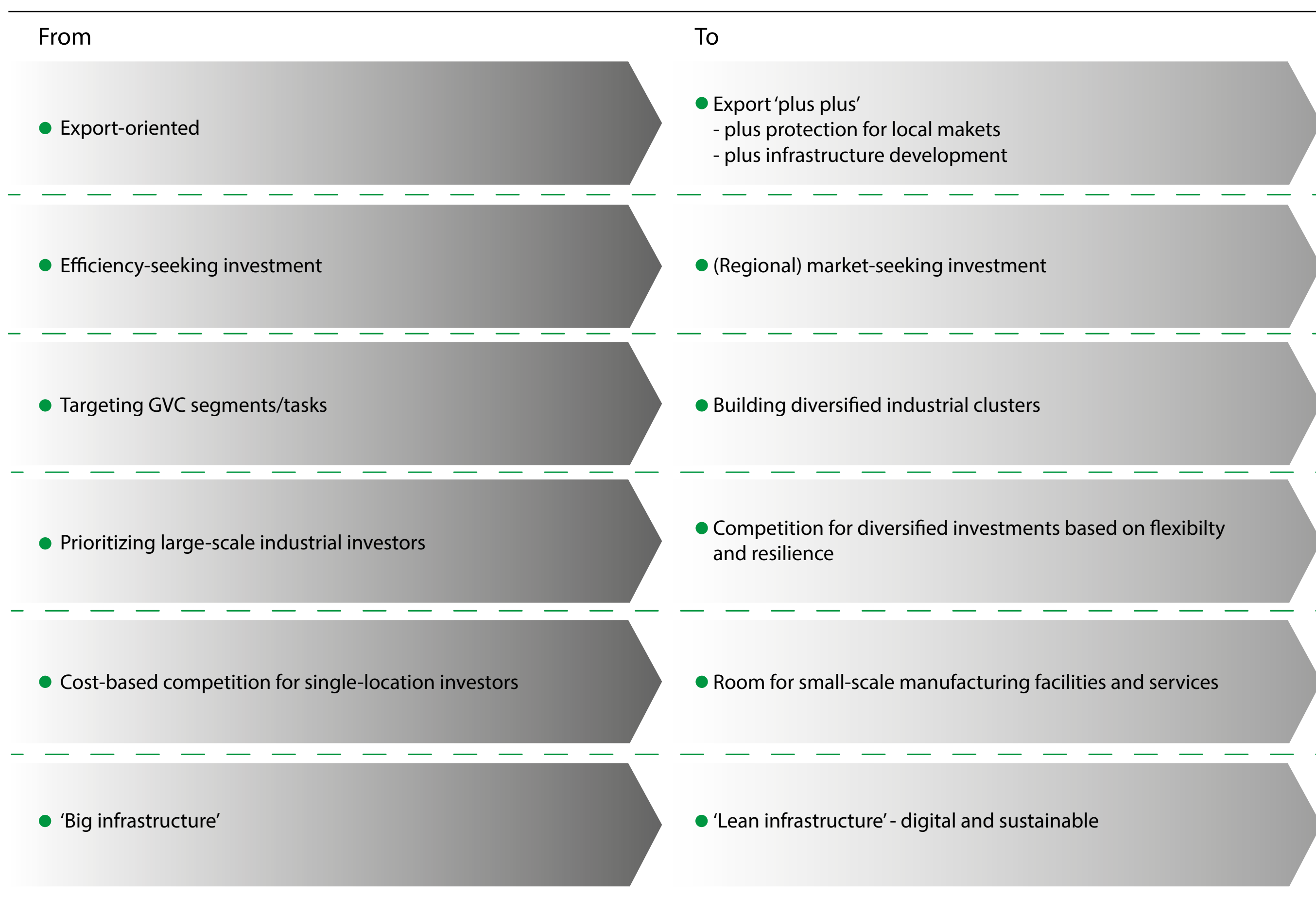
Opportunities arising from the transformation include attracting investors looking to diversify supply bases and building redundancy and resilience. The pool of regional market-seeking investment will increase. Shorter value chains will bring more investment in distributed manufacturing and final-goods production with broader industrial capacity building and clustering.

And digital infrastructure and platforms will enable new applications and services and improve bottom-up access to GVCs. The sustainability imperative will lead to more green and blue investment and value chains.

Confronting the challenges and capturing the opportunities requires a change in the investment-development path (Figure 3). From a focus on export-oriented efficiency-seeking investment in narrowly specialised GVC segments, the focus needs to be reoriented towards a broader export-led strategy which extends to investment in production for regional markets and regional industrial clustering.

Similarly, there needs to be a shift in focus from cost-based competition for single-location investors to competition for

Figure 3. Towards a new GVC development path



diversified investments based on flexibility and resilience. And from prioritizing large-scale industrial investors with 'big infrastructure' to making room for small-scale manufacturing facilities and services with 'lean infrastructure'.

Finally, a shift in investment promotion strategies towards infrastructure and services is necessary. For the past three decades international production and the promotion of export-oriented manufacturing investment has been the pillar of development and industrialisation strategies of most developing countries.

Investment geared towards exploiting factors of production, resources and low cost labour will remain important, but the pool of such investment is shrinking. A degree of rebalancing towards growth based on domestic and regional demand and on services, as well as the green and blue economy, will be the new path forward. ■

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The impact of GDPR on data flows and national security

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The Court of Justice of the European Union recently delivered its verdict in the Schrems II case, ruling that the EU-US Privacy Shield is invalid. This column addresses the implications for adequacy and standard contractual clauses as well as the broader issue of how to balance national security and privacy goals. It concludes with observations about the potential impact of the decisions for the US and beyond and suggests some ways forward.

The recent Court of Justice of the European Union (CJEU) decision in Schrems II finding that the EU-US Privacy Shield is invalid and its additional findings with respect to standard contractual clauses, closes off key mechanisms for transferring persona data from the EU to the US, with important impacts on trade and the development of technologies such as cloud computing and artificial intelligence (AI).

This is the second time the CJEU has found that the General Data Protection Regulation (GDPR) mechanisms for transferring personal data from the EU to the US is invalid[1].

The earlier CJEU decision in Schrems I found that the European Commission adequacy decisions with respect to the EU-US Safe Harbour was invalid[2]. An adequacy decision is a finding by the European Commission that a third countries privacy laws are essentially equivalent to the rights and obligations under the GDPR[3].

The importance of data flows for transatlantic economic relations necessitates that the US and EU engage in a third attempt to develop a mechanism that can enable data flows and pass muster with the CJEU.

However, whether this remains a fruitful path forward is uncertain in light of what we now know about the approach of the CJEU to adequacy under GDPR. In particular, the focus on how government agencies access data for national security purposes is becoming the key barrier to data flows between the EU and the US.

More broadly, the CJEU decision makes clear that all the key GDPR mechanisms for transferring personal data from the EU to third countries are unstable, namely adequacy decisions, standard contractual clauses (SCCs) and binding corporate rules (BCRs)[4].

In this respect, the CJEU decision will have ramifications beyond its immediate impact on data flows between the EU and the US. The following addresses the explicit CJEU findings on adequacy and SCC as well as the broader issue of how to balance national security and privacy. The paper concludes with observations about the potential impact of the decisions for the US and beyond and suggests some ways forward.

In this column I focus on two key issues at play in this most recent Schrems case: (1) the disconnect between application of EU law to national security agencies in third countries compared with domestic security agencies; and (2) and the severe limits the decision places on existing GDPR mechanisms for transferring personal data from the EU to third countries. I also offer observations on what this will means for data flows, and in particular the implications for small and medium sized enterprises (SMEs).

Privacy and security in a world of global data flows

A core issue in both Schrems cases was how national security agencies operate to preserve security and also ensure sufficient levels of privacy, and whether this is consistent with GDPR.

The attempt by GDPR to extend EU privacy rights and obligations to countries and entities receiving EU personal data reflects a broad dynamic, which is that as the global free flow of data increases the scope for national security agencies to access the personal data of everyone, national privacy standards need to be globalised as well to be effective.

Yet, governments often provide different levels of privacy protection and redress depending on whether a person is a citizen and where they are located. Under the Fourth Amendment to the Constitution, the US provides different levels of legal redress to people in the US compared to those outside the US, including access to US courts. GDPR in effect seeks to extend the full suite of rights and obligations available in the EU under GDPR, to any country receiving EU personal data.

Underlying the CJEU decision in Schrems I and Schrems II that invalidated the EU-US Safe Harbour agreement and in this most recent case, has invalidated the EU-US Privacy Shield, is a disconnect between the GDPR's international impacts, and

its domestic application to member state national security agencies.

In both Schrems cases, the issue was US government access to personal data for national security purposes and the rights of EU citizens in the US to judicial review and redress. In both cases the CJEU found that the US fell short in that the US was not according EU personal data the protection and rights of redress available in the EU.

When it comes to access to data for national security purposes, under EU law, including GDPR, any limitation on EU rights to privacy must be 'necessary and proportionate'[5]. At the same time, national security is the sole responsibility of member states[6].

In effect, each EU state is given the discretion to balance national security needs with data privacy rights. Yet, the EU is not according a similar discretion to third countries.

In fact, GDPR uses the threat of withdrawing access to EU personal data as a tool to seek reform of other country's security agencies to reflect the CJEU notion of proportionality, while exempting member state governments from similar expectations or threats. This effectively sets up the CJEU as the arbiter of whether other countries' approaches to accessing data for national security purposes are proportional[7].

This disconnect between GDPR's international and domestic application when it comes to national security also risks EU demands becoming increasingly detached from the reality and practices of national security agencies.

On the one hand, the outcome in the US between security and privacy reflects US constitutional constrains, national security needs and privacy concerns.

In the EU, it does not appear that any such balancing took place, leaving the EU approach to privacy untouched in important ways by the equities and needs of member state national security agencies.

The result is a set of demands on third country national security agencies that the EU does not, and could not, make of its own national security agencies. This dissonance between what the EU is expecting of other governments and what it is able to ask of its member states is compounded by various findings that EU data may in fact be safer and accorded better due process when in the US than in the EU[8].

The inadequacy of adequacy decisions

The issue with how the US government accesses data for national security is what lead the CJEU in both Schrems cases to invalidate the European Commission's adequacy finding with respect to the US. This Schrems decision also makes clear that not only adequacy decisions but also SCC and BCRs are much more limited than originally thought.

Another consequence of the Schrems decision is to underscore the fragility of these GDPR data transfer mechanism. As the Irish High Court and CJEU overturns a second adequacy finding by the Commission, the CJEU has made clear that SCCs (and BCRs) may require data flows to be terminated at any point should the processor in the third country be unable to comply with GDPR, either due to requests from a third government for access to data or due to changes in legislation.

"…what is needed is an international agreement on how to balance national security and access to data, with other key goals such as privacy"

These outcomes will inevitably increase risk for businesses that rely on cross-border transfers of personal data. This will affect not only the large tech companies but also those in manufacturing and services that are increasingly data driven.

To understand the implications of this decision for these GDPR transfer mechanisms, it is helpful to reflect on the institutional incentives and priorities driving the different finding by the European Commission on the one hand, and EU domestic courts and the CJEU on the other.

The European Commission in making an adequacy decision weighs a range of goals that are in tension with each other. While focused on assessing whether US laws and practice are adequate under GDPR, the Commission also takes into account the impact of stopping flows of personal data on international trade, investment and diplomatic relations.

In contrast, the process for challenging an adequacy finding rests upon findings by a National Data Commissioner, findings by domestic courts, and finally the CJEU. None of these bodies is expected to consider the range of issues at play for the Commission.

Instead, the question is more narrowly whether the third country provides a level of privacy protection consistency with the Charter of Fundamental Rights of the European Union. It is these competing institutional incentives and focus that helps explain the different conclusions as to whether the US confers adequacy.

These internal institutional tensions raise several issues for the EU. First is the validity of other adequacy findings. For instance, what does the Commission really know as to how national security agencies in Israel, Japan or Argentina collect, use or share EU personal data.

Second is the stability of any adequacy findings. The narrow focus of the CJEU on consistency with the EU Charter and demand for essential equivalence leads very little room for different approaches to privacy in other countries, reducing scope for adequacy findings and to using any transfer mechanism under GDPR.

When it comes to determining whether the actions of other governments in collecting data for national security purposes

are consistent with GDPR and the EU Charter, the vague standard of proportionality has led the Commission and CJEU to different conclusions regarding the adequacy of US limits and safeguards[9].

Taken together, this suggests that all adequacy decisions by the Commission must be treated as potentially suspect and open to being declared invalid by the CJEU.

Another impact of this Schrems case is to limit the availability of SCC (and BCRs)[10]. The issue with SCC (and BCRs) is that it is a contractual obligation that does not bind other governments. Therefore, where practices by national security agencies for accessing personal data are inconsistent with GDPR, SCCs do not obviously remedy this problem.

The CJEU nevertheless held that SCCs remain valid where the controller adduces additional safeguards that rectify these gaps[11]. It is not clear what these safeguards are or how they could work in practice.

Another wrinkle here is the finding by CJEU of the accountability for processors in the EU to ensure that the legislation in the third country allows the data processor to comply with the SCC, before transferring personal data[12].

It is not clear whether this merely requires comparing third party laws with GDPR or also the practice of national security agencies, which is harder to assess but arguably what should matter the most.

The result is that after Schrems II, all GDPR mechanisms for transferring personal data to third countries are much more limited in scope, durability and stability.

Some implications of Schrems II for cross-border data flows, trade, privacy and security

The first thing this Schrems case makes clear is the extent of the tension created by GDPR between balancing access to and use of data, and the privacy rights and obligations in GDPR (Mattoo and Joshua Meltzer 2018).

The EU view is that they can have strong privacy and a strong digital economy, including cross-border data flows, and this is likely correct at a certain level of abstraction.

However, the details of GDPR now make clear how GDPR sets up real tensions and trade-offs in terms of getting what the EU wants under GDPR in terms of privacy, and access to and use of data consistent with a robust engagement in the digital economy and digital trade (Jia *et al*. 2019).

In practical terms, Schrems II calls into question the availability of adequacy findings, SCCs (and BCRs) as reliable and stable mechanisms for cross-border data transfers. If the US is still not adequate, then it must be the case that other countries, including China will never be adequate and not only that, but it is hard to see how any Chinese company collecting EU personal data can transfer it back to China consistently with GDPR. Large companies may have to localise data storage and process in the EU.

Yet for small companies, the impacts are most pronounced. For many, setting up in the EU is not an option. There are SCCs, but depending on the government, additional safeguards may be needed for SCCs to be viable.

Again, it is unclear what such safeguards may be or whether SMEs could implement them even if they exist. The CJEU decision also establishes an obligation on processors in third country to notify controllers in the EU of changes in legislation that prevent compliance with a SCC.

This is an additional monitoring burden on SMEs in third countries and failure here can expose these companies to liability for harm caused to EU data subjects. The difficulties with SCCs also create additional costs and disincentives for EU companies to develop digital supply chains with SMEs in third countries.

As discussed, another issue at play is the balance between how security agencies use data for security, and also protect personal privacy in a globalised world. It is likely that GDPR is too unilateral and too EU-specific, and that national security is too important, for GDPR to lead to the types of changes the EU needs for an adequacy finding to work.

The EU bet with GDPR has been that the economic importance to US companies of allowing cross-border data flows of EU personal data will be enough to force the US to reform how its national security agencies collect and use data.

This has been a somewhat reasonable bet so far in that the US has shown a willingness to negotiate and engage in some reform. But even here, US reforms in order to obtain an adequacy decision have been limited and as we now know, not enough.

It is also the case that the trend is not in the EU's favour. For while the economic importance of data grows, so do the security issues related to data flows. In fact, the trend is arguably towards security becoming a more important organising principle for how digital economies develop and where data flows.

Given this, the risk is that GDPR fails to lead to enough US reform that can justify another adequacy finding, forcing the EU into self-imposed data isolation.

In such an outcome, large US and other companies will still service the EU market but the EU will become increasingly closed, reducing access to large global data pools and the opportunities for insights and the machine learning that underpin AI developments that the EU seeks to develop (European Commission 2020).

Given these risks and developments, what is needed is an international agreement on how to balance national security and access to data, with other key goals such as privacy.

Such an outcome could be deemed an international agreement under GDPR article 45(2(c) that would support an adequacy finding and by extension, short up access to SCC and BCRs. ■

Author's note: the author was an expert witness for Facebook in the latest proceedings before the Irish High Court.

Endnotes

1. Schrems and Facebook Ireland v Data Protection Commissioner (hereinafter "Schrems II")(2020) CJEU Case C-311/18
2. Schrems v Data Protection Commissioner (hereinafter "Schrems I") (2015) CJEU Case C-362/14
3. EU General Data Protection Regulation, 27 April 2016, L119/1 (hereinafter 'GDPR'), art. 45(3)
4. SCCs are included in contracts that bind entities in a third country to processing personal data consistent with GDPR; BCRs are commitment international conglomerates make to treat personal data consistent with GDPR when transferring data overseas within other units, to treating personal data consistent with GDPR,
5. Charter of Fundamental Rights of the European Union, article 52(1); GDPR art. 23
6. Treaty of the European Union, article 4(2) provides that "national security remains the sole responsibility of each EU Member State."
7. Schrems II, paragraph 178
8. European Agency for Fundamental Rights 2015. "Surveillance by Intelligence Services: fundamental rights, safeguards and remedies in the EU"; Sidley Austin 2016. "Essentially Equivalent -A comparison of the legal orders for privacy and data protection in the European Union and the United States", January 2016; Opinion of Geoffrey Robertson QC [https://www.bcl.com/downloads/RobertsonSafeHarbour.pdf], 14th January 2016.
9. Schrems II, paragraph 176
10. Commission Decision of 16 December 2016 amending Decisions [2001/497] and [2010/87] on standard contractual clauses for the transfer of personal data to third countries and to processors established in such countries, under Directive [95/46] (OJ 2016 L 344
11. Schrems II, para 133
12. Schrems II, para 144

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