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The Cashless Society

While technology is rapidly eliminating paper currency, profligate spending is eroding future financial flexibility.

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The 2017 Tax Cuts and Jobs Act, aggressive fiscal spending, and a growing global economy should boost economic and corporate profit growth and also be supportive of equity markets. However, the looming increase in the U.S. federal deficit from the tax cuts bears close watching. In this issue of *Global Foresight*, we explore the rise of consumer, corporate and fiscal debt. Jimmy Chang examines our fiscal situation in detail, with a focus on the rising budget and current account deficits, while Louie Sobong and Jake Tran look at how the migration from cash to cashless payment systems has taken hold in various parts of the world.

Introduction

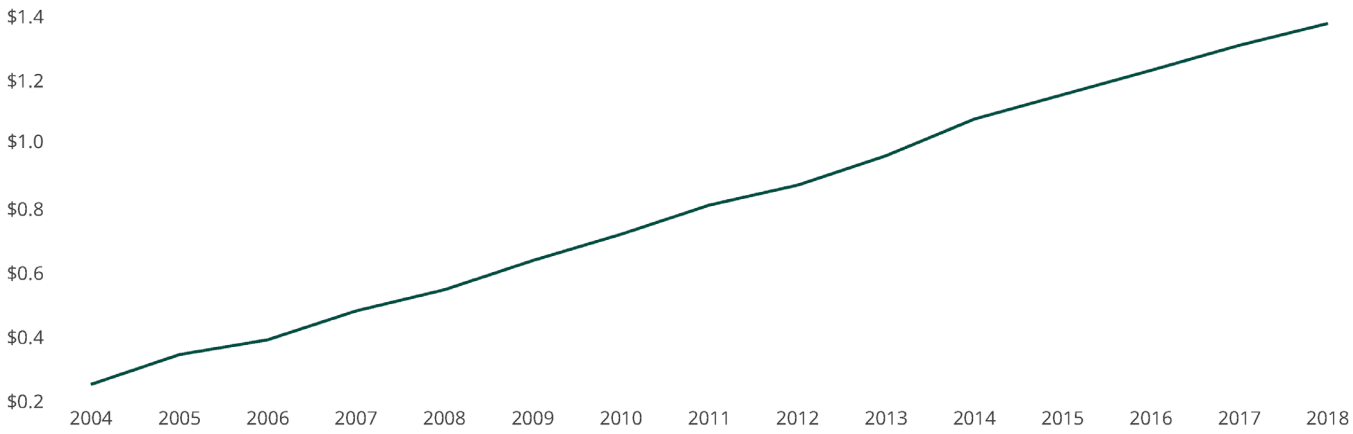
Our elected leaders face a temporal conflict between allocating resources to today's voters versus addressing the needs of future generations. Consider the unusual plight of the 10th President of the U.S., John Tyler, who was born in 1790 and served in office from 1841 to 1845. While President Tyler may have wanted to make the world a better place for his grandchildren, he probably never envisioned that two of them would still be alive as of 2018 — a seemingly impossible circumstance, 177 years after he became President. Tyler was alive when George Washington was President, and his grandsons are alive when Donald Trump is President.

In terms of resource allocating between today and future generations, Trump's tax cut passed in late 2017 and his federal budget for the fiscal year starting October 1, 2018, will increase an already large fiscal deficit during a period of economic growth when deficits typically do not expand. Not only is the U.S. federal government spending freely, but consumers are once again living beyond their means, as the savings rate has dropped to levels only seen during 2005 to 2007. In addition, many corporations have joined the debt binge, outside of the cash-rich technology sector.

The two biggest longer-term economic growth challenges the world faces are debt and aging demographics. However, both could create near-term tailwinds to economic growth that could mask the longer-term issues. Consider U.S. baby boomers, who were born between 1946 and 1964. Their rise into adulthood coincided with a large expansion in economic activity during the years they reached their ages of peak productivity in the labor force. However, as the oldest baby boomers are now 72 and have been retiring in increasing numbers, we are also seeing their impact on economic growth in the U.S. Throughout most of the 1960s until 2005, U.S. annual economic growth typically exceeded 3.0%. However, growth has yet to exceed 3.0% since the financial crisis, a period coinciding with the oldest baby boomers just reaching early retirement age.

Photo source: Getty Images

CHART 1: **U.S. STUDENT LOANS** (IN TRILLIONS)



Source: Federal Reserve Bank of New York

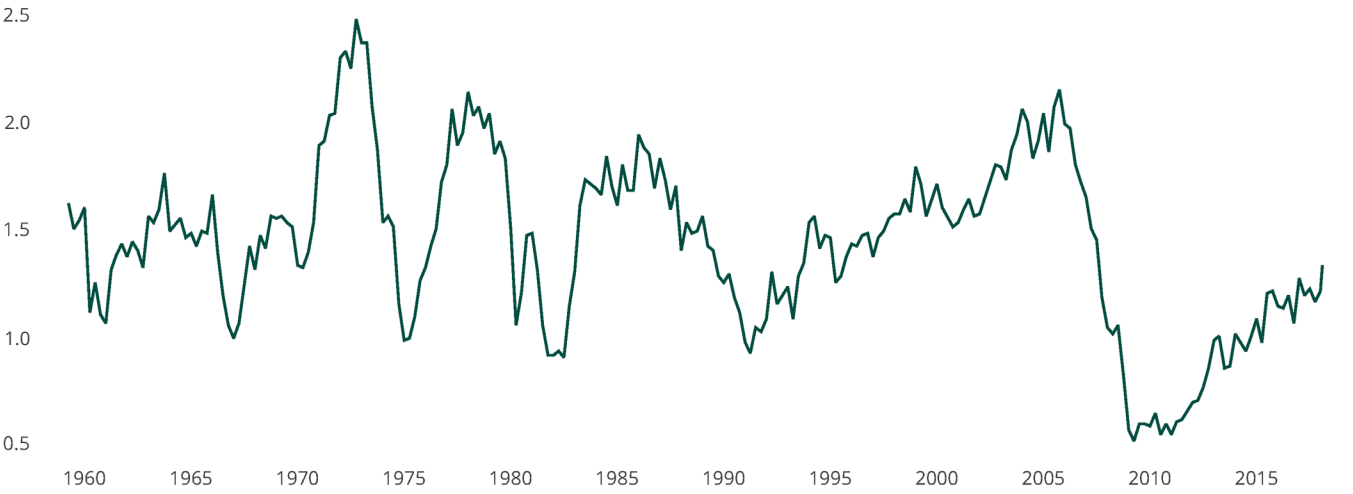
The notion that the tax cuts will generate sustainable 3.0% economic growth to pay for themselves is not credible and does not square with economists' forecasts of growth just below 3.0% for 2018 and 2019. The headwinds of aging baby boomers and the strained financial position of young people are likely constraining what should be even more robust growth. We have seen a significant rise in indebtedness of college graduates from their student loans as shown in CHART 1. These loans have grown at a much faster pace than the growth in the cost of tuition. While overall consumer debt has come down since the financial crisis, our college graduates are increasingly burdened with student loan payments.

In addition to student debt, many young people rack up substantial credit card debt before they even turn 21. Of those 18 to 20 year olds who have credit cards, Experian estimates they owe on average $2,800. For 21 to 34 year old card holders, the number balloons to over $5,900 in debt.

Coinciding with the rise in student debt and credit card usage has been the slowdown of new household formation. Not only are most young adults settling down later in life, but they are having smaller families than their parents' generation. This is evidenced by the number of new homes being built in the U.S., which is still recovering from post-financial crisis lows. Nearly 10 years after the financial crisis, the number of new homes being built is only back to levels seen in the early 1960s when the U.S. had only 180 million people compared to roughly 330 million today (CHART 2). Consensus forecasts for new home construction have the units merely rising to about 1.35 million by 2020.

The second biggest expenditure for most households is an automobile. Similar to the historic data with housing, auto sales have not been growing on an historic basis, with levels today barely back to those seen 20 years ago when the population was 276 million.

CHART 2: **U.S. HOUSING STARTS** (IN MILLIONS)



Source: U.S. Census Bureau

CHART 3: **U.S. AUTO SALES PER CAPITA** (CARS SOLD PER 100 PEOPLE)

Source: Bloomberg

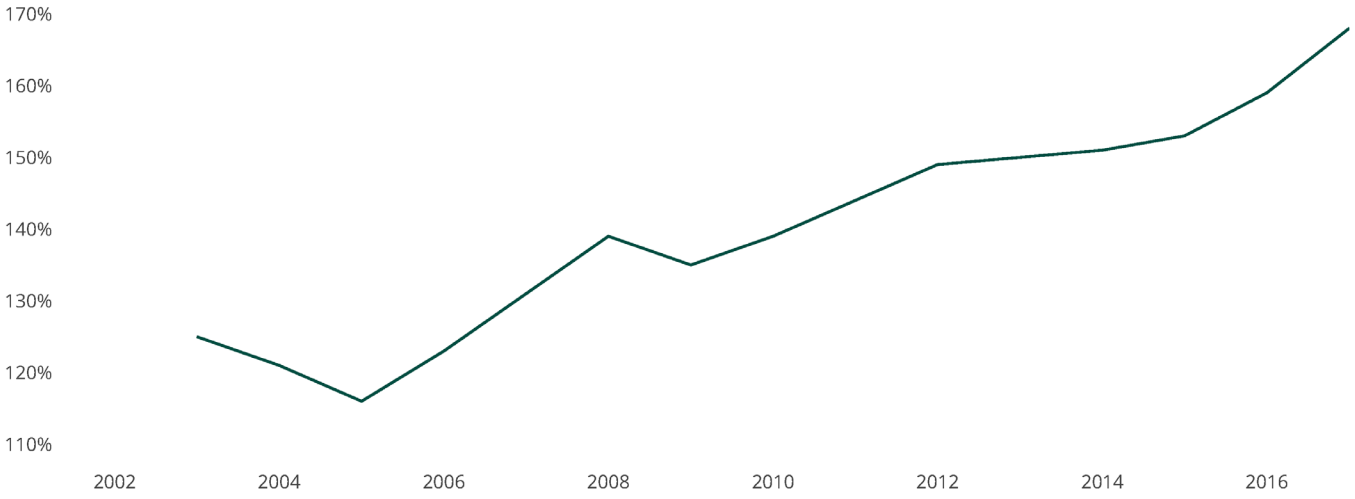
Excluding periods of economic weakness, we now sell fewer cars per capita than we have historically done (CHART 3).

There are many factors one can point to for why the volume of housing units and per capita auto sales in the U.S. have seemingly topped out. Certainly a growing preference by younger people for experiences, such as travel or dining out is a factor. Also, if you graduate with a mountain of student debt and have a balance on your credit cards, this will likely weigh on your ability to buy a home or car or even start a family.

The use of credit cards, which have only been widely available to the last generation of college students, has likely permanently altered consumption patterns. There is an important psychological aspect to credit cards, as it is more tempting to spend when transactions occur on plastic, or increasingly on your phone or via an app, than when you are forced to use cash.

The slowdown in household formation and population growth is actually a global phenomenon that largely tracks the rise in consumer debt and consumption amongst young adults. CHART 4 shows the household debt in South Korea, which not coincidentally also has the lowest fertility rate in the developed world. Low interest rates have kept the debt servicing costs manageable, but the absolute amount of debt is well in excess of the size of the South Korean economy. South Korea's economy used to grow over 10% a year in the 1970s and 1980s, but since 2010 this has slipped to a 3.0% annual growth rate. This is not a cyclical slowdown, but the dual forces of debt and demographics capping growth.

CHART 4: **SOUTH KOREAN HOUSEHOLD DEBT AS A PERCENTAGE OF GROSS DOMESTIC INCOME**



Source: OECD (Organisation for Economic Co-operation and Development)

CHART 5: **S&P 500 CONSUMER STAPLES INDEX NET DEBT** (IN BILLIONS)

Source: Bloomberg

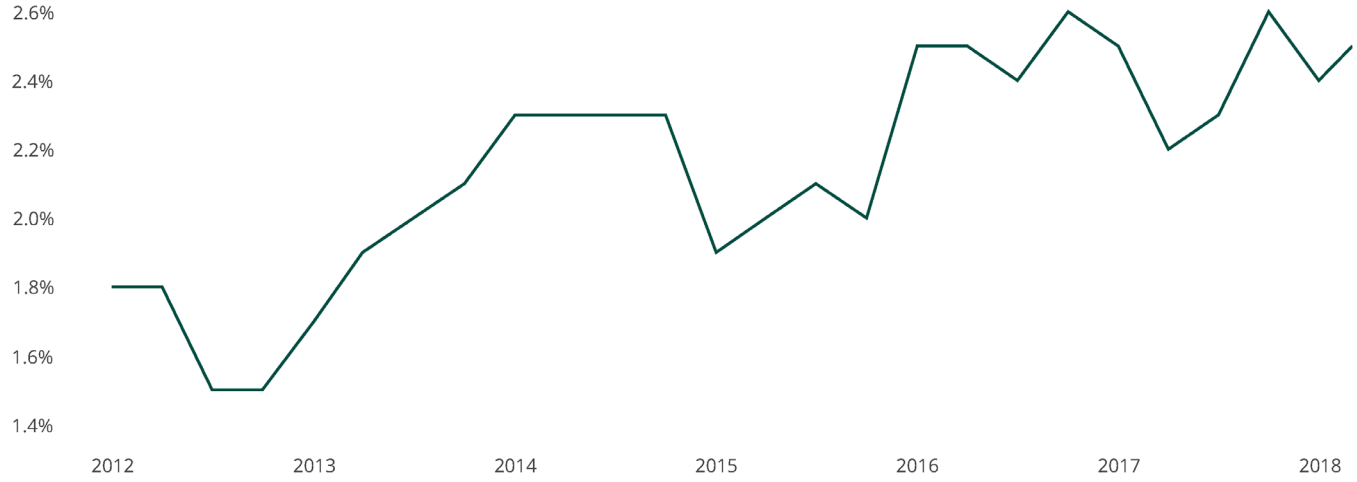
The Myth of Corporate Cash

Beneficiaries of the new tax law include corporations, which benefit both from the lower statutory rate on U.S.-based earnings, as well as from a cut in the rate for repatriated earnings. Companies with significant overseas cash balances formerly faced a 35% tax rate and will now pay a rate of only 15.5% on cash brought back to the U.S. Moody's recently estimated that U.S. companies have about $1.4 trillion in stranded cash overseas. However, that cash is concentrated, with only five large tech companies — Apple, Alphabet, Oracle, Microsoft, and Cisco — accounting for about half of it. When we analyze the balance sheets of other sectors, we struggle to characterize most U.S. corporations as being "cash-rich." In fact, most have been capitalizing on low interest rates to gorge on debt and buy back shares. The best example of this is seen in the consumer staples sector, which has largely relied on increased debt to fund share buybacks to offset slow or declining revenue and net income (CHART 5).

Charts of the telecoms and utilities sectors look very similar to that of consumer staples. These sectors tend to be steady and generate cash and tend to support relatively high debt loads. However, most have already levered up over the last several years and used their increased debt load to eke out respectable earnings per share growth despite weak revenue and net income growth. Should interest rates continue their upward ascent that we have seen thus far in 2018, it will likely get much harder for these sectors to replicate this feat of generating earnings per share growth over the next several years. Even without increasing their debt to fund further buybacks, many of these companies may see their interest expense rise as they roll over existing low-rate debt. Ordinarily, the economic resilience of telecoms, staples and utilities make those sectors appealing in an economic downturn as their companies tend to hold their value. If the next downturn is accompanied by higher rates, however, the stock prices of even these traditionally defensive sectors may struggle.

Photo source: Shutterstock

CHART 6: **U.S. AVERAGE HOURLY EARNINGS YEAR-OVER-YEAR**



Source: Bureau of Labor Statistics

The Other 44%

The most recent Federal Reserve Report on the economic well-being of U.S. consumers was published last May and was based on a survey from October 2016. This is the fourth annual survey and the data have improved only marginally even as the economy and the jobs market have gotten better. Over eight years into an economic recovery, and with unemployment near the lows seen in the 1960s, an astonishing 44% of adult Americans would be unable to come up with $400 from savings in the case of an emergency, according to this Fed study. While overall consumer debt levels have improved since the financial crisis, a number of adults are still living paycheck-to-paycheck.

There are important implications resulting from these 44% of adults with little or no savings. With a tight labor market and many folks still struggling, perhaps we are finally about to see wages accelerate for lower-earning workers.

CHART 6 shows some recent improvement in wages after years when hourly pay was stagnant. The trajectory and sustainability of wage growth will likely be the key to whether inflation is creeping back into the U.S. economy. So far the evidence is mixed, but with unemployment so low, we may finally be nearing a tipping point for inflation and potentially even higher interest rates.

Another key implication is how little cushion so many have for the next downturn. Not only does the U.S. government have little flexibility for the next recession, with already very high and growing debt and deficits, but a significant proportion of the population appears strapped financially.

> "While many Americans are doing much better financially and have in aggregate improved their personal balance sheets from the depths of the financial crisis, the other 44% represents a number of potentially dissatisfied voters."

While many Americans are doing much better financially and have in aggregate improved their personal balance sheets from the depths of the financial crisis, the other 44% represents a number of potentially dissatisfied voters. Investors will be closely monitoring the U.S. midterm elections this November as a key barometer for 2020.We could see a major reversal in tax policy in 2021 to cope with our fiscal debt.

Conclusion

The U.S. economy has enjoyed a long steady recovery and now has a double-dose of stimulus through the Tax Cuts and Jobs Act of 2017, as well as a very expansionary federal budget for the fiscal year starting October 1, 2018. The stimulus from each should provide visible economic growth for at least several quarters. In addition, the tax cut will likely boost earnings of corporate America by an extra 8% for 2018. Between a weaker dollar, a good global economy and the tax cuts, U.S. corporate profits are expected to jump by roughly 15 to 20% in 2018, making previously elevated equity valuations more reasonable after the robust market gains of 2017.

Equities have rarely experienced substantial declines when earnings growth is good and economic growth is steady. However, there are some proverbial storm clouds brewing for 2019 and beyond that are important to monitor. While consumer debt (for a segment of the population) and student debt are real issues, our national debt is far and away the most challenging one we see in the long run.

Photo source: Getty Images

For the tax cuts to be a longer-term success, we will need to see sustained economic growth to help generate the revenues to pay for them. We are facing a big increase in our already high level of federal debt that will need to be reckoned with at some point. With steady economic growth like what we have experienced over the last eight years, that day of reckoning may be years away. However, it is important to note that entering the last five recessions (1974, 1981 to 1982, 1991, 2002 and 2008 to 2009), the U.S. debt to GDP ratio was only 31%, 31%, 55%, 55%, and 64%, respectively. With the debt to GDP ratio already at 103% for 2017, we have far less financial flexibility to deal with the next economic slowdown than we had during 2008.

Our fiscal debt has not been an issue to date as it has been masked by low rates, with the average interest rate on U.S. marketable debt at roughly 2.2% compared to about 4.0% in 2008. Italy and Japan are the only major economies with higher fiscal debt to GDP and they have been helped by even lower rates on their debt. Importantly, Japan funds its debt internally, whereas the U.S. relies on China, Japan and others to buy its Treasuries. Relying on others to finance debt is not an ideal plan as any young adult knows who has had to move back into their parents' basement. ●

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Evil Twins & the Ghost of Smoot-Hawley

Rising twin deficits to pressure greenback; trade war on the horizon

Mr. Raj should have known better when he got into the business — a kind of courier service that was highly profitable, but potentially deadly in Malaysia. You see, Malaysia has some of the harshest laws against drug trafficking — death by hanging was made mandatory in 1983. A person would be considered a drug trafficker for possession of "dangerous drugs" above certain thresholds — one kilogram of opium, 200 grams of cannabis, etc.

In 2003, luck ran out on the 21 year-old Mr. Raj. He was caught red-handed for unloading drugs from his car into a house in suburban Kuala Lumpur. The police found 366 pounds of cannabis and 3.7 pounds of raw opium in the car. Amid the commotion of the arrest, Mr. Raj's brother showed up at the house and was promptly handcuffed and taken into custody as well.

The case against Mr. Raj seemed like a slam dunk — two arresting officers were at the crime scene, and DNA samples were collected. However, there was just one wrinkle — the Raj brothers, Sathis and Sabarish, were identical twins. Once they were fitted with prison garb in the slammer, the two arresting officers could not identify which brother was the perpetrator of the crime. The DNA evidence also could not tell them apart since the DNA of identical twins is 99.9% identical.

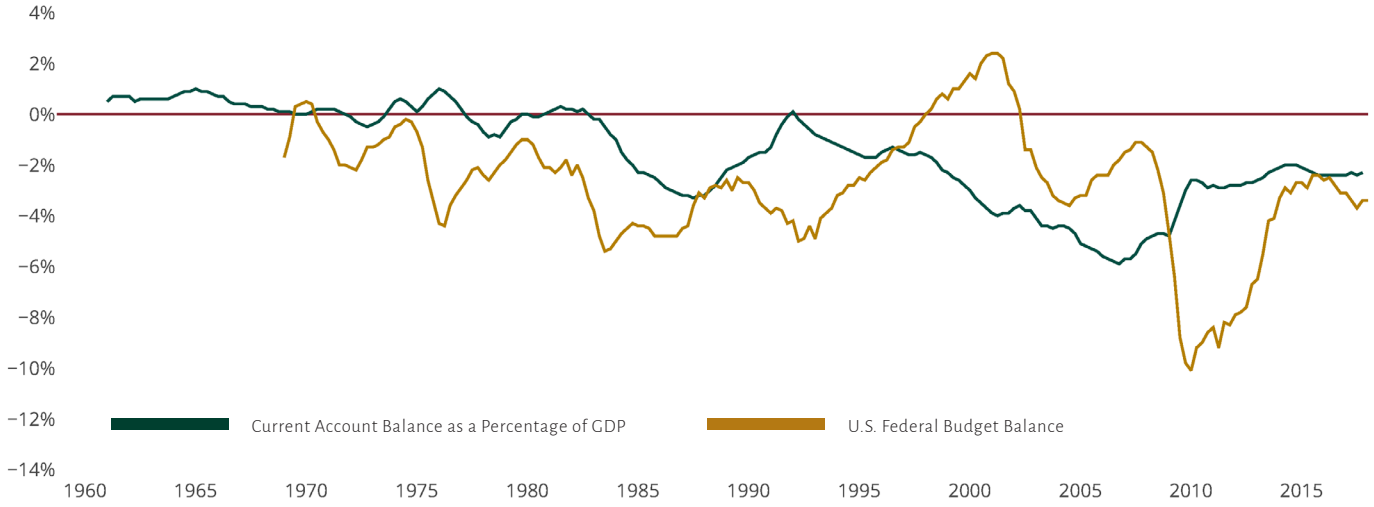
In 2009, Malaysia's High Court Judge Zaharah Ibrahim determined that the first twin arrested was clearly in possession of the drugs. However, since there was no way of identifying which of the Raj brothers was the first twin arrested, she decided to acquit the two of all charges on the basis that she "can't be sending the wrong person to the gallows."

The Raj brothers cried and embraced family members after the verdict was handed down. Their luck did not run out after all.

Twin Deficits

The economic and investment professions also have their share of "twin" stories, though none comes close to the Raj twins in dramatic effect. There were the *Bretton Woods twins* — the creation of the World Bank and the International Monetary Fund (IMF) at the 1944 United Nations Monetary and Financial Conference in Bretton Woods, New Hampshire

CHART 1: **U.S. FEDERAL BUDGET BALANCE AND CURRENT ACCOUNT BALANCE AS A PERCENTAGE OF GDP**



Source: Bloomberg

— to regulate the post-war international monetary and financial framework. The term *Twin Crises* was coined in the 1990s in the wake of several emerging market countries' concurrent banking and currency crises.

The best known twins in our industry are perhaps the *twin deficits* — the causal link between a country's budget deficit and its current account deficit. The term gained prominence during the 1980s when President Reagan both increased military spending and cut taxes, which widened the federal budget deficit. These actions also coincided with the U.S. current account balance turning negative (CHART 1). The current account measures a country's net trade balance plus net income, as well as net fund transfers from abroad. For practical purposes, a country's current account balance is closely tied to its trade balance. A current account deficit indicates that the country has a trade deficit and is a net borrower to the rest of the world.

The twin deficits took a hiatus in the 1990s. The U.S. enjoyed an unusual period of budget surplus from the mid-1990s into the early 2000s as the government's coffers were filled with rising revenues during a 10-year long economic expansion. The current account even climbed into the black, albeit just briefly in 1991, thanks to a $54 billion payment from our coalition partners for the First Gulf War to liberate Kuwait from Saddam Hussein's Iraq.

The twin deficits re-emerged in the 2000s as the budget surplus turned into deficit due to President George W. Bush's tax cuts and the post-9/11 War on Terror spending. The Great Recession blew an even bigger hole in the nation's finances and led to four straight $1 trillion plus deficit years. During President Obama's second term, the federal deficit returned to more normal levels thanks to an improving economy, budget sequestration, and higher taxes.

On the current account side, the deficit kept widening into the middle of the 2000s with the trade deficit being fueled by soaring crude oil imports and China's growing manufacturing prowess. Ironically, it took the Great Recession to narrow the U.S. current account deficit as the economic malaise reduced America's voracious appetite for foreign goods and services. In recent years, our current account balance was further helped by reduced energy imports (thanks to the growing shale energy production), as well as by lower oil prices. However, over the last few months, the U.S. trade deficit has steadily moved up again, with the January 2018 monthly deficit hitting the highest level since October 2008.

Why should investors care about the twin deficits? The "crowding out" theory postulates that a higher government deficit could push up interest rates and leave less money for the private sector. A persistently high current account deficit could put a country at the mercy of foreign creditors, resulting in higher borrowing costs and lower currency value. These theories, however, were not always confirmed by empirical data because the real world had other factors at work. As a case in point, the surge in budget deficit in the aftermath of the Great Recession was accompanied by *falling* U.S. Treasury yields as the Fed unleashed ultra-loose monetary policies.

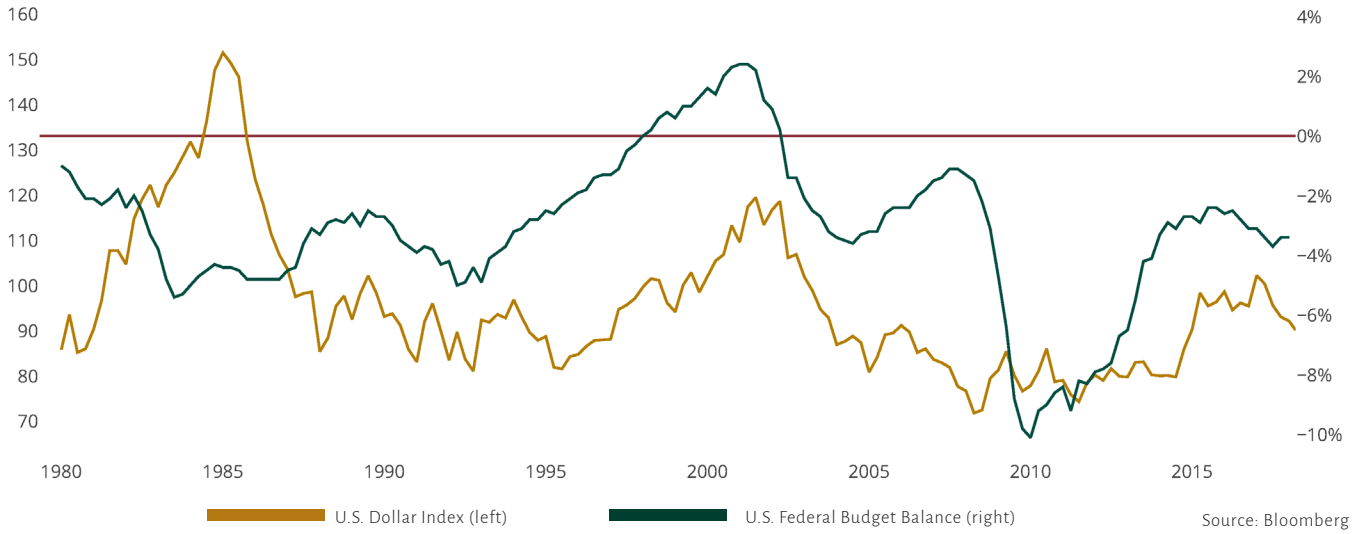
On the other hand, since the late 1980s, the change in the size of the U.S. budget deficit has preceded moves in the U.S. dollar — as the budget deficit shrank, the greenback subsequently rallied, and vice versa (CHART 2).

Make Debt Great Again

President Trump, the self-professed King of Debt, has already come up with his 2020 re-election campaign slogan — *Keep America Great!* Indeed, the U.S. economy has been exhibiting upward momentum and business, and consumer confidence has reached multi-decade highs as well.

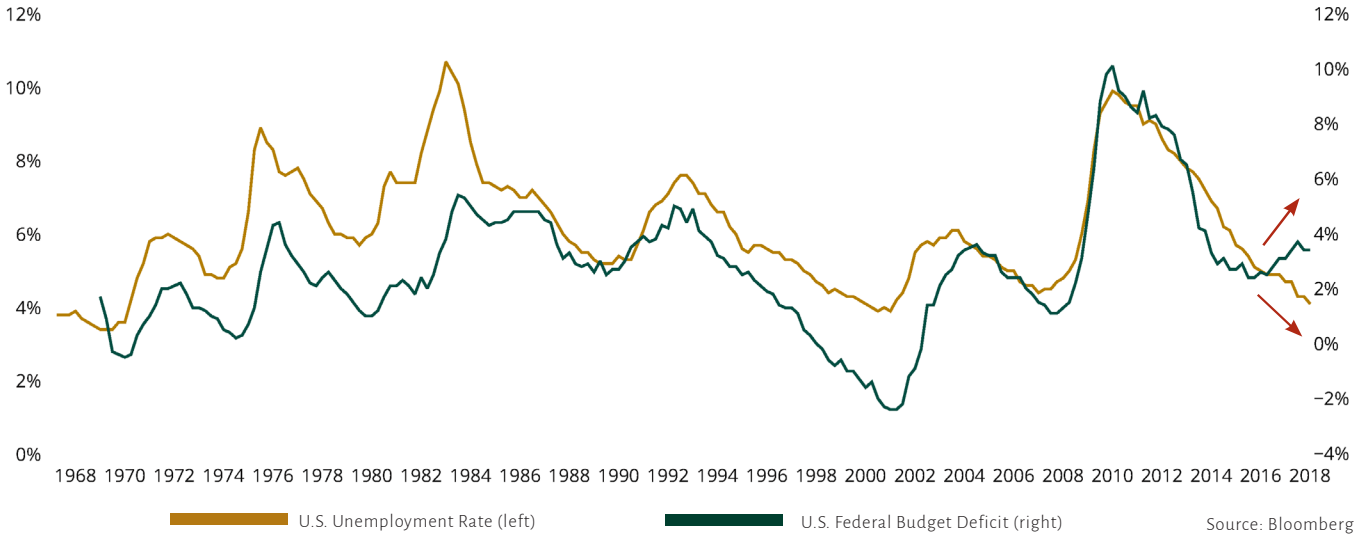
The so-called Trumponomics are built on a three-legged stool — de-regulation, tax cuts, and increased fiscal spending. These are potent policy tools that should prime the pump going into 2018's midterm elections. However, in spite of all the talk of the

CHART 2: **U.S. DOLLAR INDEX VERSUS U.S. FEDERAL BUDGET BALANCE AS A PERCENTAGE OF GDP**



Source: Bloomberg

CHART 3: **U.S. UNEMPLOYMENT VS. FEDERAL BUDGET DEFICIT**



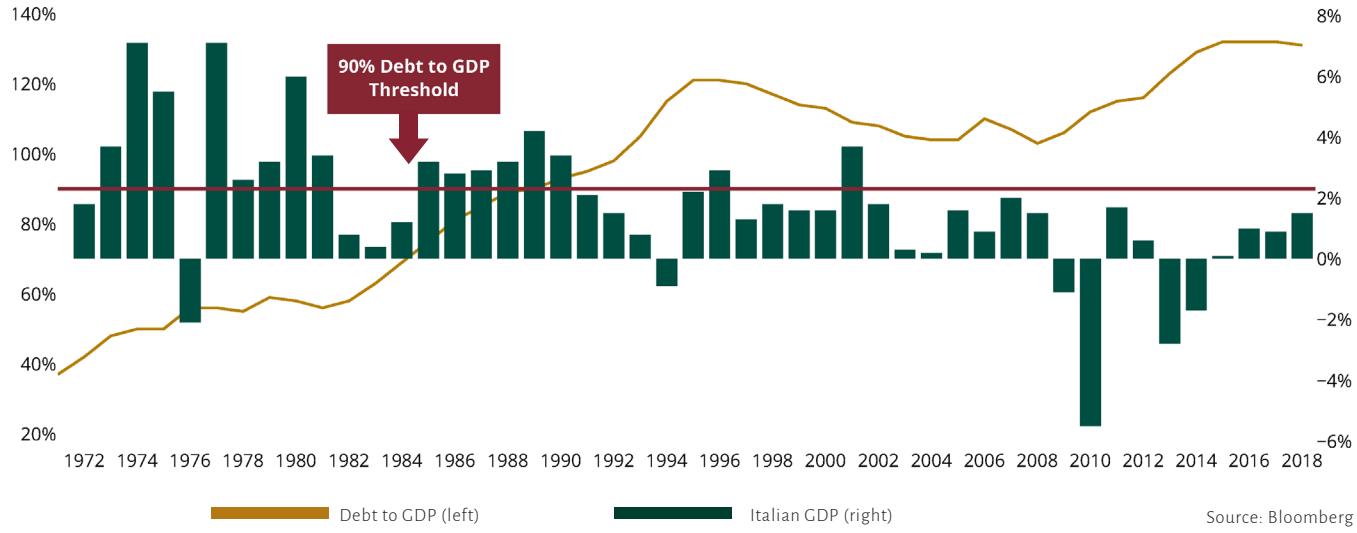
Source: Bloomberg

stimulus-induced prosperity, consensus expectation for U.S. GDP growth has remained relatively subdued — just 2.8% and 2.4% real growth for 2018 and 2019, respectively. Recent data on consumer spending has also been underwhelming, prompting economists to revise down their first quarter growth estimates. It makes one wonder about long-term prospects if the U.S. real GDP growth cannot get above 3%, even with the help of big tax cuts and increased government spending.

The Trump Administration and Republicans on Capitol Hill, however, would not buy into such a downbeat assessment. The Office of Management and Budget's (OMB) February 2018 budget report projected real GDP growth of 3.0%, 3.2% and 3.1%, respectively, for 2018, 2019 and 2020. It then straight-lined 3% annual growth through 2024. In spite of these rosy growth assumptions, the budget was still projected to wind up with nearly $1 trillion of deficit for 2019 and 2020.

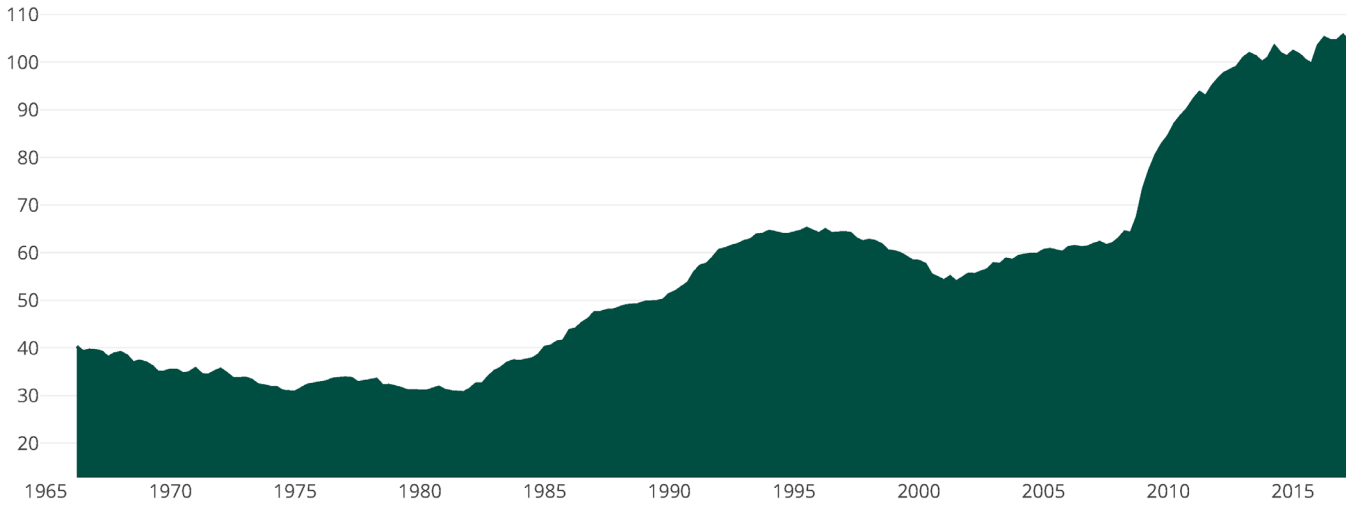
To put things into perspective, the current economic expansion is about to enter its ninth year, and our 4.1% unemployment rate is the lowest in nearly 18 years. As shown in CHART 3, periods of low unemployment have historically led to a shrinking budget deficit or even a surplus — it does not take a financial genius to figure out that the budget deficit should be brought down during boom times. Herein lies the problem — the annual U.S. budget deficit is now on course to surpass $1 trillion, roughly 5% of GDP, in what is likely the latter stage of an economic expansion. What will happen when we encounter the next recession which will inevitably reduce the government's tax revenue? Surprisingly, President Trump and his newly minted National Economic Council Director Larry Kudlow recently floated the idea of a "phase two" of tax cuts. Given the rapidly rising deficit, one has to wonder if this is voodoo economics gone wild or a mistimed April Fools' joke.

CHART 4: **ITALIAN GDP GROWTH VERSUS DEBT TO GDP**



Source: Bloomberg

CHART 5: **THE RAPID CLIMB OF THE GROSS U.S. DEBT TO GDP RATIO SINCE THE GREAT FINANCIAL CRISIS**



Source: Bloomberg

Various studies have observed the linkage between slower GDP growth and elevated debt levels, usually above 90% of GDP. As shown in CHART 4, Italy ran into this issue as its debt became elevated; over the last 17 years, its real GDP growth has not exceeded 2%. Italy was able to chip away at the debt during the boom time starting in the mid-1990s. The currency union in the Eurozone further aided Italy's finances by bringing down its borrowing costs, as well as trade barriers. Unfortunately, unbeknownst to Italian policymakers 10 years ago, the Global Financial Crisis was right around the corner and would unleash a rapid climb in the country's debt-to-GDP ratio. Currently, the U.S. debt-to-GDP ratio is where Italy's was shortly before the Great Financial Crisis (CHART 5). There is the distinct possibility that, during the next recession, our government's straight-line growth projections will prove to be wishful thinking, and our debt-to-GDP level will set to spike up again.

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No Free Lunch

The combination of the widening budget deficit and the recent surge in trade deficit has brought the twin deficits back on investors' radar screen. Over the near term, our deficit-financed stimulus is likely to generate continued expansion in consumer spending, corporate profits, capital spending and jobs. In the long run, however, our creditors may exact a pound of flesh in the form of higher interest rates, lower currency value, or both.

There is the irony that this deficit-financed fiscal largess at a time of near-full employment could push up inflation and compel the Fed to quicken the pace of policy normalization. As the Fed shrinks its balance sheet and the European Central Bank winds down its asset purchase program, there should be less demand from these price-insensitive buyers. This could help push bond yields higher around the globe. Rising bond yields and elevated leverage make a rather unsavory cocktail for not just the U.S. government's mountain of debt, but also for the highly levered corporate borrowers. They would likely hinder economic growth and potentially even lead to recession, which could conceivably occur before the 2020 general election.

The U.S. dollar has depreciated about 13% on a trade-weighted basis during the last 15 months. This was taking place during a period of strengthening U.S. economic growth, tightening monetary policy, rising real and nominal interest rates, and big fiscal stimulus — factors that should have strengthened the greenback. The U.S. dollar weakness, in our opinion, reflects investors' rising concern about America's profligacy. Larry Kudlow may have been aware of this concern and tried to talk up the dollar shortly after he was appointed Trump's top economic advisor — "*I would buy King Dollar and I would sell gold*." The verbal intervention may work in the near term, but we believe the broader trend for the U.S. dollar is likely to be continued depreciation unless other major economies start to exhibit even greater degrees of fiscal profligacy or political instability.

Ghost of Smoot-Hawley

One way to reduce the U.S. current account deficit is to improve its trade balance. In 2017, the U.S. ran up $566 billion of trade deficits with $2.985 trillion of imports and $2.329 trillion of exports. The trade deficit has long rankled Donald Trump — during an interview with Oprah Winfrey in 1988, he blasted U.S. allies for not paying for defense, singled out Japan and Kuwait for selling too much to us, and said he was "tired of seeing the country ripped off." As such, Trumponomics may just add a fourth leg to the stool — protectionism.

As is typical of Trump's braggadocio, he recently tweeted that "*trade wars are good, and easy to win*." If history is any guide, this cavalier tweet would turn into one of those infamous last words. In 1930, Congress passed the Smoot-Hawley Tariff Act which raised tariffs on over 20,000 imported goods. It triggered retaliatory trade measures among our trading partners and was believed to have exacerbated the Great Depression. From 1929 to 1934, it was estimated that world trade had declined by 66%.

Photo source: Twitter

After generating much controversy with tariffs on steel and aluminum imports, President Trump has proposed to impose tariffs on up to $60 billion of Chinese imports. The proposed tariffs relate to an investigation of China's alleged intellectual property rights violations. With China accounting for 66% of our trade deficit in 2017, President Trump cannot make much of a dent in the trade deficit without getting concessions from China. However, over the near term, the biggest casualties will be U.S. consumers, as many Chinese imports cannot be quickly replaced.

It is difficult to handicap how any Trump trade war would play out. On the positive end of potential outcomes, the president's threat of "reciprocal tariffs" may drive our trading partners to lower barriers against U.S. exports. On the other end of the spectrum, there could be a mutually destructive tit-for-tat that winds up damaging the global economy. We suspect the likely outcome will be somewhere in between — President Trump raises tariffs on a few imports, triggers some retaliatory responses, holds a few trade summits, claims victory and moves on. However, the trade negotiation process could be chaotic and disruptive to financial markets and business planning.

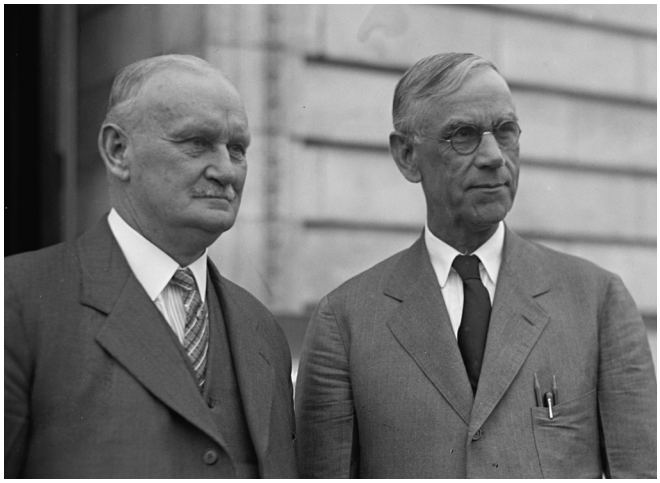

Photo source: Wikipedia

Investment Implications

With the U.S. dollar potentially moving lower as a reaction to the mounting deficits, we believe global equity and non-U.S. equity strategies are likely to experience a multi-year period of outperformance over U.S. large cap stocks, similar to the trend in the first half of the 2000s. Among U.S.-domiciled companies, multinationals with sizeable overseas exposure should also benefit from the weaker greenback. However, some of them will be at the mercy of President Trump's protectionism and China's calculation on the trade-off between retaliation and concessions. Precious metals may also shine again due to the inverse relationship with the U.S. dollar.

Unlike the Raj twins who found absolution via a technicality, our twin deficits are unlikely to get a break without some tough fiscal medicine. In May 2016, then candidate Trump created quite a stir with the comment "I would borrow, knowing that if the economy crashed, you could make a deal." So far, "The King of Debt" has been borrowing aggressively as promised. As for his penchant to "make a deal" on the debt, we would put that in the same category as "trade wars are good." There is a limit to his unconventional approach to governing, and, in time, we fear there could be a strong backlash from the market. That said, one should not be surprised by Trump's unconventional presidency, since he has actually been delivering on his campaign promises. The real tragedy is that many erstwhile self-styled fiscal hawks on Capitol Hill have mutated into chickens — their political expediency has seemed to outweigh their fiscal probity. It will be up to the Federal Reserve to do the heavy lifting during the next downturn, which is not yet on the horizon, but whose eventual return is as sure as the sun will rise. The interesting question is whether the U.S. Treasury will still be viewed as a traditional safe haven. We think so, but we worry that Washington's ongoing fiscal profligacy could make it less so. ●

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More Electronic Money, Less Problems

Governments across the world are attempting to move away from paper currency

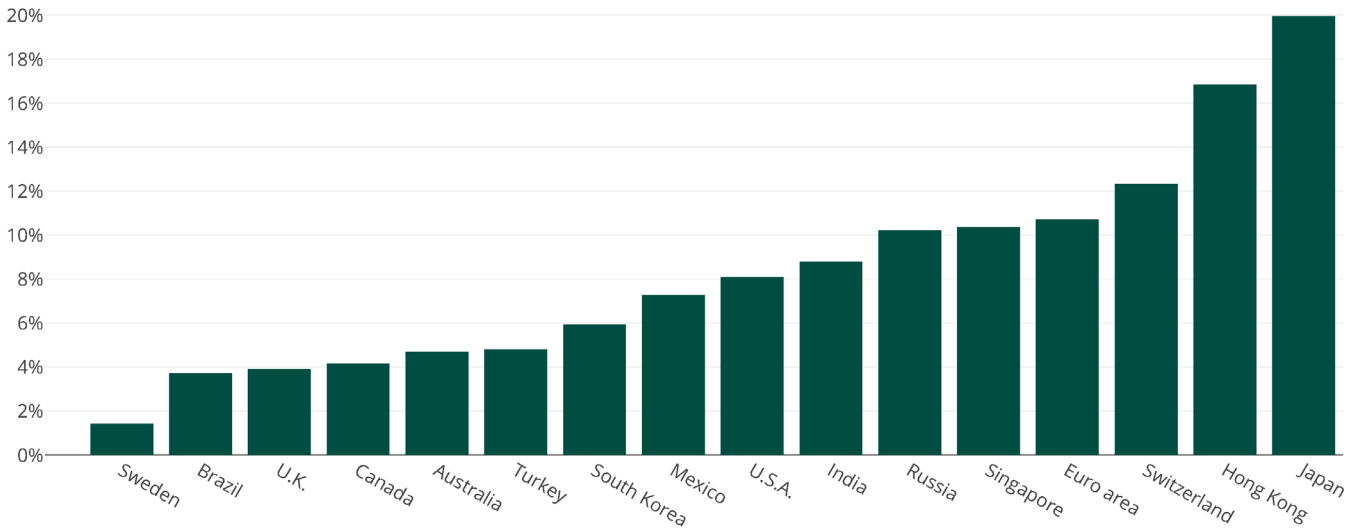
The Swedish people can be credited with making quite a few aspects of life easier for us. From IKEA furniture to Tetra Pak packaging, Scandinavia's largest economy can also be considered a pioneer in making our lives at the checkout easier, with Swedes embracing electronic forms of payment in lieu of physical currency. While cryptocurrencies have dominated the headlines, the transition away from physical currency has been taking place for years. To put things into perspective, the market cap of all cryptocurrencies at the end of March stood at $280 billion, which is dwarfed by Visa, which processes $10.5 trillion in transactions, annually. The reasons for making such a transition are plentiful: combating fraud, crime, higher tax receipts, and removing a big cost at banks.

Sweden's banks are among the most efficient and profitable in the world, and this has continued to improve as the economy has reduced its cash usage (CHART 1). Over half of the country's bank branches no longer handle cash, reducing staff needs and handling costs. Both ATM transactions and currency in circulation are down by over half from 10 years ago.

In addition to bank branches, many of Sweden's retail shops, museums, and restaurants have stopped accepting cash altogether. Churches in Sweden accept much of their weekly collections via smartphone apps. *Situation Stockholm*, a newspaper run and distributed by the city's homeless, has been accepting card payments for a number of years. Even some public toilets have eschewed cash for access, now only accepting payments via card or smartphone.

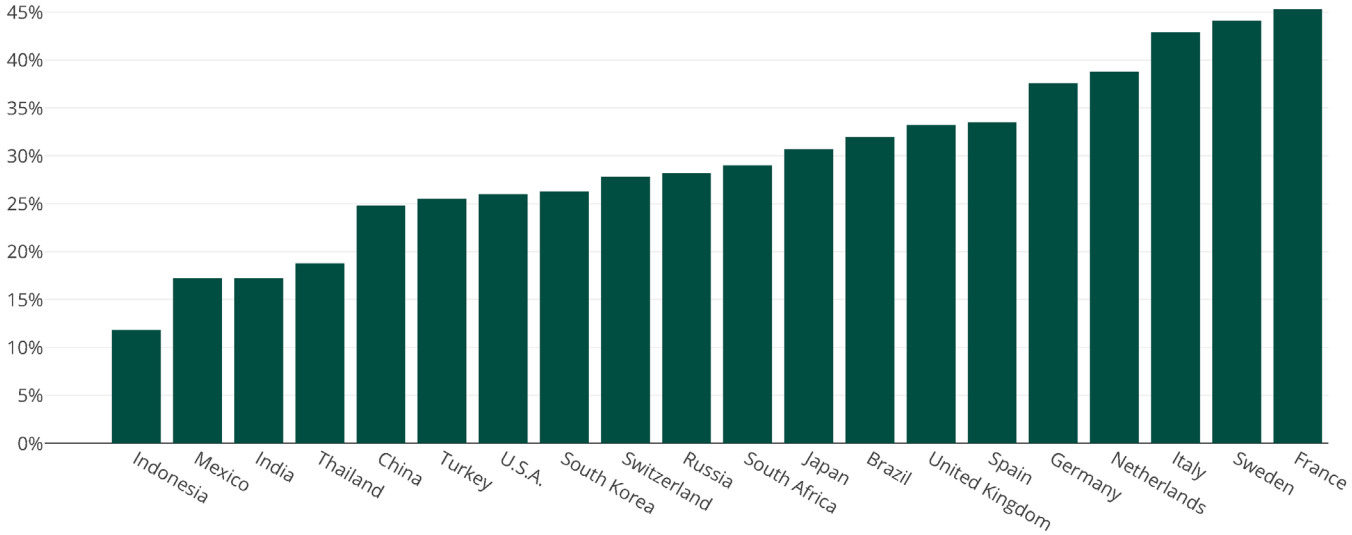
The rapid penetration of the Swish app has been indicative of consumer adoption of electronic payments. Launched just over five years ago by the major Swedish banks, Swish allows consumers to send or receive payments to and from fellow app users or for retail purchases. The app now boasts 6.2 million users, which represents over 60% of the country's population. The dwindling acceptance of cash has prompted some concern from regulators and consumers, particularly in regards to meeting the needs of the elderly. Despite some inconvenience, consumers have largely embraced the move to cashless. A recent survey suggests that only a quarter of Swedes conducted a cash transaction at least once a week.

CHART 1: **CASH AS A PERCENTAGE OF GDP**



Source: Committee on Payments and Market Infrastructures (CPMI), Bank for International Settlements

CHART 2: **TAX AS A PERCENTAGE OF GDP**



Source: Livemint

Two-thirds of Swedish consumers say that they are completely able to manage without cash.

Given the pushback from the elderly in Sweden, it is no surprise that one of the world's oldest populations — that of Japan — has been less keen to make the leap. Cash in circulation as a percentage of GDP in Japan is among the highest in the world. As tourism plays a bigger role in the economy going forward, in addition to ensuring the 2020 Olympics in Tokyo are a success, the Japanese government is trying to encourage acceptance of alternative payment methods at merchants, and doubling digital payments to 40% of transactions over the next decade. In a country where some interest rates are negative and loan demand lackluster due to a greying population, this would be a welcome change.

"Opportunities are not limited to just the financial services sector: merchants will need to roll out infrastructure to accept alternative forms of payment."

Emerging Markets

Brazil is an example of an early adopter of electronic forms of payment. While economic growth has been hampered due to political scandal and poor fiscal planning, use of financial technology has provided a welcome boost to the consumer. In a country where crime is high, security guards at bank branches are one of the biggest expenses for its banks. With less cash in the system, citizens can feel safer when transacting both in bank branches and in stores.

Achieving broad adoption of electronic payment methods can be very arduous given the change that needs to occur in consumer behavior and merchant investment. At the forefront of modern day disruptive technologies, Uber still accepts cash in India. Around 60% of online purchases still use cash on delivery as the preferred method of transacting. The prevalence of the underground economy may also be a factor here, with the World Bank projecting that the informal sector accounts for around a quarter of GDP. On November 8, 2016, in an unprecedented move, President Modi decided to remove high (it's all relative) denomination 500 and 1,000 rupee notes ($7.70 and $15.4 respectively), equivalent to 86% of currency in circulation, in an effort to reign in the informal sector, better known as the underground economy. Though the underground economy may be associated with illicit activities, it also encompasses workers who may be paid in cash for their labor, thus enabling the evasion of taxes. Massive queues formed at banks overnight, as citizens moved to exchange their soon-to-be useless currency. Of the notes that were outlawed, 97% were deposited into banks. While causing mass disruption, the longer term opportunity from such a move and impact on the economy should be cause for optimism. In a country where tax evasion is high, formalizing the monetary system should go a long way in combating this issue. Relative to other countries, India has done a poor job of collecting tax, as measured by tax revenue as a percentage of GDP (CHART 2).

The need to address this is exacerbated by the relatively large current account deficit. Increased tax revenue should provide

Photo source: Shutterstock

a welcome boost to government coffers. Tax returns being filed increased 24% year over year, while tax collections increased 19% in the three month period ending July 2017, the last period before the new Goods and Services Tax (GST) system was rolled out.

Deposit growth in the banking sector surged to 16% in the month following demonetization, while loan growth has yet to fully recover. In the immediate aftermath, such dynamics manifested themselves in lower yields in Indian government debt, as banks hurriedly invested their newfound excess deposits. Inflows into savings products offered by insurance companies and banks have also received a welcome boost. With insurance penetration so low in a country where gold is often viewed as an attractive vehicle for savings, we should see a continuation of demand for more orthodox savings methods. Opportunities are not limited to just the financial services sector: merchants will need to roll out infrastructure to accept alternative forms of payment. Merchant acceptance of electronic payments has doubled in the past year to 2.5 million locations, yet terminal penetration is still among the lowest in the world. WhatsApp, a popular messaging service which boasts 230 million users in the country, will be launching a peer-to-peer payments service, ensuring citizens make full use of their new bank accounts. When getting a mobile phone is more of a priority than a bank account (88% of households have a cell phone, yet only 53% of adults have a bank account), as personal finances improve in emerging economies, it is logical for companies such as Samsung and Apple with their mobile wallet offerings to continue to blur the lines between financial services and technology.

With one of the world's youngest populations, which is rapidly growing, India has the benefit of a demographic dividend. They are expected to overtake the Chinese to become the world's largest population by 2024. Cashing in on this potential and ensuring the economy prospers requires investments in infrastructure and education; improvements in government finances that should coincide with demonetization would go a long way in helping to ensure these essential expenditures occur. ●

Sources:

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