The Executive Forum

American and Global Economic and Financial Challenges

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Address by

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It is pleasure being with you this evening and I particularly want to thank Ted Cunningham for inviting me.

The stock markets are at, or close to, all-time highs and this may be an expression of optimism about the future. Unemployment here in the United States has been declining and economic growth has started to move towards more reasonable levels.

But these are most difficult and turbulent times. Once again our forces are flying missions in the Middle East; our troops are in daily combat in Afghanistan; tensions with Russia over Ukraine are most serious; nor should we underestimate tensions between China and Japan; while negotiations with Iran about its nuclear program are not going well.

Alongside these geo-political concerns, we have a world economy that has so few bright spots that global attention, more than ever, is on growth in the United States in the hope that somehow we can lift all boats.

Global trade, which has long been a crucial driver of the international economy, slowed significantly in the first half of 2014 after only modest expansion in 2013. The World Trade Organization has noted that world trade growth was at an annual rate of 1.8% in the first half of this year, but it expects the rate for all of 2014 to be 3.1% -- this compares to just a 2.2% rate of growth in 2013. To get some perspective, we should recall that as we emerged from the Great Recession we saw world trade grow at 13.9% in 2010 and then by a still reasonably healthy 5.4% in 2011. The weak performance we are now seeing in world trade growth reflects the multiple difficulties that continue in many economies.

This evening I would like to focus on some of the key global economic challenges, first highlighting the world's largest economies - the U.S., China, Japan and the Eurozone, which now comprises 18 countries – then briefly touching upon emerging markets, and concluding with a few thoughts on the investment risk environment that has emerged and that I think should concern all of us. Then I would be delighted to expand on these issues in our question and answer session.

The United States

The United States remains the most powerful economy in the world. The good news is that our financial markets are strong; our banking system has recovered well from the financial crisis; our employment rate has fallen below 6%; and, our real growth, while still below our potential, is heading towards an annual rate of around 3% from the 2% level of recent years. Moreover, we are becoming the world's largest producer of oil and natural gas, which is placing downward pressure on energy prices and which will reduce our import bills and our dependence on foreign sources of supply.

Nevertheless, real incomes for most Americans have barely increased. Persistent worries about the outlook and the legacy of the Great Recession have combined to boost savings, which is a good thing as debt levels were unsustainably high. But, confidence - so vital to boosting demand and investment -- remains low and middle-income Americans have not seen the prosperity that a small percentage of the wealthiest Americans have enjoyed.

Importantly, the sustained health of our economy demands that our political leaders address fundamental policy issues that have festered for too long. Perhaps the results of the elections in two weeks time will be a spur to constructive leadership in Congress. The facts are that we need to be concerned about the medium- to long-term financing of the combination of major entitlement programs – Social Security, Medicare, Medicaid and the consequences of the Affordable Care Act (Obamacare). Without changes in these programs and without meaningful tax reform, young Americans face the rising prospect of seeing their nation live increasingly beyond its means. This danger already dampens long-term investment prospects and will increasingly do so.

The revival of the U.S. economy in recent years has been due to heavy reliance on monetary policy – a fact that is evident today in most economies. Fiscal policy and structural reform and deregulation policies have not played their full part in securing greater investment and growth.

So now, today, all eyes remain fixed on the Federal Reserve Board. The markets have largely accepted the ending of quantitative easing, which I think is essential given the enormous growth from $800 million to over $4.5 trillion in the

Fed’s balance sheet.

Uncertainties remain as to when the Fed will permit increases in interest rates. I expect this will happen in the course of the first half of 2015. I expect that from the perspective of domestic economic growth, the Fed will manage this process quite well. The Fed itself acknowledges that we cannot be complacent about the impact of rising interest rates here on the longer-term competitiveness of U.S. exporters as the dollar may well gain in strength, or on the impact on international financial markets. Rising interest rates will serve as a magnet for financial flows into our economy and out of a wide range of foreign economies, from the Eurozone to Latin America, and place challenges to policy-makers there as a result.

China’s Important Changes

China is the world’s second largest economy and it in a period of fundamental political and economic change. We are in the Xi Jinping era. He is already emerging as the most powerful leader of China since Deng Xiaoping. And he is being tested on many fronts.

The President is committed to strengthening the domestic image of the Communist Party by rooting out corruption. His efforts on this front also serve to consolidate his political position. He has pledged to directly address the mounting environmental problems that confronting the country, especially its largest cities. Then, he has to address the aspirations of increasing number of Internet-wired Chinese for a greater say in governance, with the events in Hong Kong being significant here. Moreover, he must manage relationships with his Asian neighbors,

notably Japan, and ensure a reduction of tensions in the South China Sea.

All of these matters add significance to the manner in which President Xi will demonstrate leadership and strengthen cooperation at the forthcoming Asia-Pacific Economic Cooperation Leaders' Meeting on November 10 and 11 in Beijing. Incidentally, there will be great interest on the sidelines of this summit in the bilateral meetings that President Xi is likely to have with Japanese Prime Minister Abe and Russian President Putin.

Not the least of Xi Jinping's concerns relate to China's economy. The leadership is committed to reducing the export-orientation of the Chinese growth model, while boosting consumerism. This involves convincing the Chinese people to spend more and save less. It demands liberalizing the financial sector, including the freeing up of interest rates, the introduction of deposit insurance and, in time, full convertibility of the currency.

These major changes need to take place in an environment where China can no longer expect double-digit annual economic growth. It will be a struggle this year for the government to secure more than 7% growth and part of the cost of reaching this goal will be delays in financial liberalization and in addressing profound problems in some parts of the financial sector. There is a debate taking place now in the leadership in China about the timing of measures to liberalize interest rates and introduce deposit insurance. The former maybe be delayed, which I think would be an error. There are indications that plans for FDIC-type deposit insurance may start to be unrolled by the end of the year.

Meanwhile, the government needs to ensure greater discipline and effective regulation of shadow banking, of non-performing loans in the mainstream banking sector, and the high propensity of state owned enterprises and municipalities to

borrow.

These challenges are already having international consequences and these will continue well into 2015.

Japan's "Abenomics"

Now, turning to Japan. Prime Minister Abe is struggling to secure an economic policy path that revives growth and avoids deflation. The Bank of Japan is on a very easy money course, but this is not enough. Essential tax measures have been taken and seem to be having a greater negative impact on growth than the Prime Minister anticipated. So today, more than ever, crucial actions are needed on the core structures of Japan's economy.

Without far-reaching structural reforms it will be a struggle to even attain a one percent real rate of economic growth. Current projections are that this year's rate of growth will indeed only be 1% and this is with full employment. Japan's economy is rigid. The role of the state in finance has been overly large. The Prime Minister fully acknowledges that the roles of women in business and employment have been far too small.

The government needs, for example, to assist Japanese business to become more competitive and this calls for long overdue deregulation. Then, a national energy strategy is required, especially given the public concerns about nuclear power. Importantly, fundamental structural and social policies need to be addressed – sooner rather than later – as the budget consequences of an aging Japanese population are considered.

Euro-zone Challenges

The challenges before the 18-member country euro-zone are at least as daunting as those of Japan, if not more so. Many leaders in Europe, notably at the European Commission, have continuously suggested that the region is on a growth path. My suggestion to you is to ignore the complacency and the bullishness that rings from the official quarters in Europe and look instead at the facts.

GDP performance in the second quarter was zero across the euro-zone, after a gain of just 0.2% in the first quarter. The area has failed to achieve significant growth since the 2008/09 Great Recession.

The data for the biggest three economies in the region are far from encouraging: German GDP slipped to negative 0.2% in the second quarter and recent industrial production numbers indicate that a German slump is broader than many economists have been suggesting. France has now had two consecutive quarters of zero growth. Italy is in recession with negative 0.2% in the last quarter after negative 0.1% in the first quarter. The IMF has projected that Italy's economy with decline by 0.2% this year and there have been forecasts in Italy that suggest that the decline could be greater.

The sustained stagnation across the euro-zone, year upon year, is taking a political toll. The political impact of stagnation in a country that has low unemployment, such as Germany with 4.9%, is very different to the situation in countries like Greece and Spain where unemployment is respectively 27% and 24.4%.

The danger is that radical populist parties, on the right and on the left, seize the opportunity caused by broad public anxiety over recession and joblessness. We saw this in the European Parliament elections earlier this year.

Consider the latest official data from Eurostat's August report: the unemployment rate in the euro-zone is 11.5% and more than 19 million people are officially out of work. The rate of youth unemployment, meanwhile, is at 23.8%. In such major economies as Italy and France the respective youth unemployment rates are 41.8% and 23.7%. In Spain the rate is 54.9% and in Greece it is even higher at 57.3%. For many young people a decade of lost opportunity is unfolding in Europe.

The European Central Bank moved too slowly to address the economic ailments of the euro-zone, but now it is acting. It has cut interest rates, it is directly adding to liquidity with purchases of market securities, despite criticism from the German Bundesbank, and it is pursuing a series of targeted longer-term refinancing operations (TLTROs) with a planned initial volume of around Euro 400 billion. The ECB has said it will do more if conditions demand it.

The ECB not only has to confront economic stagnation, but also the threat of deflation as the latest inflation rate across the zone at around 0.4%.

Crucial to reviving Europe's fortunes is a banking system that is firing on all cylinders. The banks account for fully 75% of the European capital markets, compared to about 25% here in the U.S., and therefore it is particularly important that bank lending increase significantly, especially to European small- and

medium-sized enterprises. Many banks took significant actions over the last year in Europe to strengthen their capital positions in preparation for stress tests administered by the ECB. The results of the stress tests will be published in coming days. They serve as a starting point for strengthening the ability of banks to lend and generate the finance needed for job creation.

I have long argued for a banking union in the euro-zone and now the ECB has the mandate to oversee its development. However, governments in euro-zone capitals will continue to push for special arrangements for banks and bank regulation in their countries and the ECB will continue to face challenges to its authority.

The critical point at this juncture is to recognize that the ECB and the banks cannot alone secure the growth that is so essential and urgent. There is a pressing need for fiscal measures that can stimulate public investment and infrastructure construction and stimulate private investment. At the same time, each country in the euro-zone needs to be more aggressive in addressing serious structural weaknesses, be they overregulation and/or excessive state ownership of real estate and enterprises, to create jobs and secure a return to sustainable growth.

Emerging Markets

Alongside the multiple economic challenges confronting each of the world's largest economies, including China, we are seeing difficulties in many emerging

market economies. They were largely spared the problems of the financial crisis and in the years directly thereafter many of them secured substantial growth, indeed they were the engines of global growth. In 2012 and 2013 they slowed somewhat to an overall average annual growth rate of about 4.6%. This year they may slip below 4%.

They should have taken full advantage of the global excesses of liquidity and low interest rates to push ahead with public investments, with structural reforms and measures to make their economies more modern, competitive and robust. Mexico did this and we are now seeing very important reforms there, notably with its energy, fiscal, and education reforms. Peru and Colombia are others that have moved forward in this regard.

By contrast, Brazil has not taken advantage of this situation. Its economy has stagnated and its domestic political tensions have increased. The election outcome later this month is uncertain, but it seems clear to me that the next government will need to take a fresh look at economic policy, promote structural reforms, and act to strengthen international confidence and investment.

Further south, underscoring the diversity that we see around us, we find the government of Argentina ever more determined to pursue a populist course as inflation soars, growth evaporates and the external debt crisis continues. It is essential that Argentina respects the U.S. court and opens the door for serious negotiations that can end its default saga. The government needs to focus on the goal of rebuilding international confidence and finding a path back to global capital market access, rather than blaming business at home and abroad for its difficulties.

One bright spot, I believe, is India. It has a new government that is likely to overcome the malaise that we have seen in recent years and move once more onto a higher growth track. South Korea too will continue, I believe, to be one of the world's most dynamic economies.

More generally and most importantly, China's slower growth has reduced demand for commodity imports, which is depressing exports and therefore growth for many emerging market economies that are large commodity exporters, be they in Asia, Africa or Latin America.

Meanwhile, the emerging market economies of Central and Eastern Europe are being impacted by both the very slow growth in Germany and across the euro-zone, as well as the mounting problems in the Russian economy.

It is crucial that as we survey the emerging markets that we recognize that so many of them today are engulfed by major geo-political uncertainties. Even before the clash with Ukraine, Russia's economy was seeing slowing growth and rising inflation. Now its outlook for growth and investment is decidedly negative. Meanwhile, Turkey, which has been doing quite well, cannot avoid the challenges, as it has to engage far more directly with Syria and the upheaval that ISIS is causing. This is bound to have a negative impact on Turkey's economy. The Syrian-ISIS upheaval is, of course, impacting all of the emerging economies of the Middle East and there is no silver lining here to give us comfort.

An important footnote on emerging markets is to consider the impact on many countries, from Russia to Venezuela to Nigeria and to the Middle East of

the fact that the U.S. is becoming the world's largest oil and gas producer. It is reducing its imports. It is impacting global prices and the cohesion of OPEC, while producing benefits for major oil importing countries like Japan that gains as world prices decline.

The Search for Yield

Yes, the U.S. stands out today as a beacon of hope in a turbulent world. But, is this really enough to justify the exceptionally high valuations that we have seen on all manner of investment assets, from London and Manhattan property, to fine art, to record stock market indexes?

In March 2007 and again in March 2008, I wrote articles in the *Financial Times* drawing attention to the rising risks in our financial system. These warnings were largely ignored, as investors were overly interested in the search for yield, and the authorities, for the most part, underestimated the gravity of the rapidly evolving crisis.

In August of this year, another comment article of mine was published in *The Financial Times*, because once more I believe we need to be concerned about financial developments. As I wrote in my article: Financial firms are dialling up risk in their search for yield due to the extraordinary amounts of liquidity created by central banks, and the prolonged low-rate environment. This is often not being done prudently.

A culture that encourages taking ever larger risks has resurfaced in financial markets to a degree not seen since before the 2007/08 financial crisis. Irrespective

of whether or not one thinks another crisis is imminent, the prevailing risk behavior that is now widespread in some banks and non-bank financial institutions alike should be a major concern for the managers and directors of financial institutions and for the regulatory authorities.

There is little evidence today that those most responsible for turning risk behavior onto a more prudent course are taking resolute action. Imprudent behavior by some traders, some loan officers and some wealth managers is being compounded by today's abundance of liquidity and the search for yield in an environment of exceptionally low interest rates.

From my own experience I know how difficult it can be to convince both top management and investment officers at the same time to reign-back and be conservative when everything seems to be going well. Senior managers and board directors at banks and other financial firms should take the lead. I fear that many of them may not do so.

Leadership

We need leadership from those most directly responsible for financial institutions to guard against excesses and the short-termism that inevitably lead to crisis.

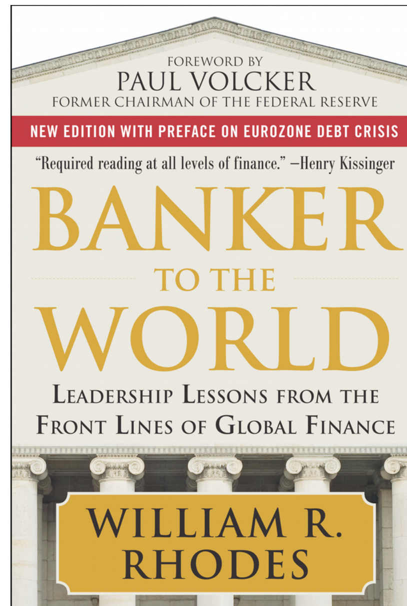
As we look across global economic and financial developments, so we have to conclude that steering the world economic ship today demands forceful political leadership.

Leadership is one of the key issues that I highlight in my book, "*Banker to the World: Leadership Lessons from the Front Lines of Global Finance.*" I am concerned about inadequate political leadership in much of the world today on economic policy, both at the national levels in the key industrial nations, and at the multilateral level through the Group of 20.

Next month, the G20 leaders meet at Summit level in Brisbane, Australia. I believe they are so engaged in very important geo-political matters, from ISIS to Ukraine, that they will not give the attention that is so urgently needed to global economic policy coordination.

For example, world trade needs to be revived as a key engine of growth. There needs to be not only a final resolution of the World Trade Organization's Doha Round and new multilateral trade agreements, but there also needs to be a powerful call by the G20 against any potential increase in protectionism.

Thank you.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