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KEY GLOBAL ECONOMIC CHALLENGES

by

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I would like to first of all thank Ted Cunningham for inviting me this evening.

I look forward to a good discussion, so permit me to first of all briefly highlight a few related global economic and financial topics that are in the news and that are worthy of consideration.

The world economy is not performing up to expectations. The United States and the U.K. may be beacons of light in the advanced industrial world. But even here at home we saw how gross domestic product shank at a seasonally adjusted annual rate of 0.7% growth in the first quarter, impacted to a degree by severe winter weather and the strikes at west coast ports. The current quarter will be significantly better. For 2015 as a whole, growth may be in the modest 2.5% range, - better, however, than in the eurozone countries.

Growth in emerging markets is also subdued. For China, the world's second largest economy, as I shall note, the era of double-digit annual growth is over. Tensions and pressures abound in nearly all the major emerging market economies. In part this is due to the slowing of Chinese growth – after all, it was indeed China's double-digit growth that fueled a worldwide commodity boom that greatly benefited many countries in Latin America, Africa and parts of Asia.

Now, let me focus on eight specific issues:

1. The enormous amount of liquidity created by central banks combined with the exceptionally low interest rate environment has produced a reach for yield in most asset classes that is often giving rise to imprudent behavior. Our stock market is at record highs; the art market has gone through the roof; the sub-prime used-car market is booming; and, the New York skyline is being changed by huge new condominium towers that seek to set soaring prices.

Given the search for yield, we need to be concerned about the risks to financial institutions and the financial system as a whole.

This is especially the case as the European Central Bank (ECB) and the Bank of Japan and the Peoples' Bank of China (PBOC) are all on a very easy money policy course, while the Fed is unlikely to move on interest rates until September.

The Fed's balance sheet exploded from $800 million to around $4.5 trillion to support economic recovery from the Great Recession and fuel growth.

There will come a time when central banks will need to restore discipline and normalcy to monetary affairs and interest rates. To achieve this - and at the same time ensure that there is an orderly unwinding of highly inflated asset valuations - will see a testing period. I have, for example, been saying for some time including in an article in *The Financial Times* in February 2014, that this may well produce severe strains in particular in emerging markets.

2. The Greek crisis can and should be solved. As I noted recently in a *Wall Street Journal* op-ed column in April, the Achilles Heel in Greece is the banking system -- there are clearly limits to ECB support for the banks in Greece and the outflows of deposits from the Greek banks will not abate, unless there is serious policy action. And, Greece needs to make Euros 1.5 billion of payments to the IMF this month.

Yes, there are important technical discussions between the Greek leaders and the Brussels Commission, the ECB and the IMF – the Troika – and even at the level of Chancellor Merkel and President Hollande. **But, when you are out of gas your car stops, and Greece is almost running on empty today.**

The Greeks have suffered five years of what amounts to a depression and today there is a need for some form of debt relief. This needs to include a long-term stretch out of debt maturities and long-term postponement of a good deal of the debt-servicing payments. In return, Greece needs to move on economic reforms, including pension and labor reforms, and restart privatization.

Forging a serious solution requires an end to the big press conferences and public rhetoric. It calls for closed-door negotiations where all parties agree that compromises must be made.

We also need to understand that if negotiations fail to resolve matters rapidly, then it will be necessary to look at the Greek banking situation the same way as we had to look at the situation in Cyprus in 2012 – a technical default forcing, for example, capital controls and major restrictions on bank deposit withdrawals.

3. But the Greek crisis needs to be seen against the background of the Eurozone's economic and political condition. Notwithstanding the fall in oil prices since last summer, the weakening of the euro, and the start of quantitative easing: the eurozone economy as a whole remains fragile.

Some people may take comfort from the fact that seasonally adjusted GDP in the 19 countries of the eurozone rose by 0.4% in the last quarter over the previous three months. The first quarter advance amounted to just 1% compared to the first quarter of 2014. Looking more closely at the three biggest economies – we find that the first quarter gain over the previous three months was just 0.3% for Germany, 0.6% for France and 0.3% for Italy.

What I keep watching – because it has such political importance – is the unemployment data. The seasonally adjusted unemployment rate in the eurozone in March was the same as in February at 11.3%, which is only down from 11.7% a year ago and it is clearly very high indeed. In Greece, latest data suggests it is around 27%; in Spain it is 23%; in France and in Italy respectively it is 10.6% and 13%. Youth unemployment in the eurozone is 22.7%; in both Spain and Greece it is over 50%; in France it is 24.4%; in Italy it is 43.1%. To place these numbers in perspective, it is worth recalling that at the peak of the Great Depression in the U.S. in 1933, the unemployment rate hit a record of 25%.

The depth and seriousness of the unemployment situation is perhaps the major cause of the rise of radical political parties in several European countries. The middle-class revolt syndrome, which I have been writing and talking about for some time, is a phenomenon that reflects broad and deep public distrust with establishment political parties.

It played the key role in the election of Syriza, the radical left-wing party in Greece; in the major victory of the Scottish Nationalists in the recent UK election; in the strong showing received by the ultra right-wing National Front party in local elections in France; and in the support for non-establishment political parties in the recent provincial and municipal elections in Spain, notably Podemus.

Indeed, Spain faces a general election in September that will be a major challenge for the ruling People's Party (*Partido Popular*) and Prime Minister Mariano Rajoy. While the government has done a good job at seeking to bring Spain out of crisis, opposition politicians are gaining support because of persistent high unemployment, especially youth unemployment. If the leftist parties decide to come together into a popular front movement in Barcelona and in Madrid, then this will be a powerful anti-establishment force, which could end up controlling both the local governments and the national government of Spain.

We need to understand that the low-growth situation of the eurozone may take some years to correct. It is far from clear, for example, whether the transmission mechanism is working efficiently – the means by which ECB quantitative easing is seeing funds go through the banking system to increase consumer and investment spending. This is crucial as the banking system in the eurozone accounts for around 80% of effective lending. I believe the eurozone has to embrace a bold growth strategy and structural reform and not just leave all the effort to monetary policy.

4. If Greece is a profound concern, then so too is Ukraine. The country plays a vital strategic role today in relations with Russia. It is a country under siege from Putin. It is a country that has substantial economic potential, which time and again has been squandered by corrupt governments.

Just over one year ago the country held elections. The government now in power in Kiev is determined to pursue meaningful anticorruption and good governance reforms and it is struggling to stabilize the economy – inflation is over 60%, GDP fell 6.5% last year and government officials are forecasting a 7.5% decline this year.

The IMF is striving to be very constructive, but its support needs to be backed up by greater generosity in our self-interest from the United States and the European Union. I believe the U.S. has committed about $2 billion so far. *The Financial Times* recently noted about the Europeans – "Europe's weak support for Ukraine gets a failing grade in economics or even elementary physics. Its official sector has provided hundreds of billions of euros to the Greek state, and perhaps €5bn to the Ukrainian government. Yet Europeans have the most to lose of any foreigners from a bad outcome of the Ukrainian situation. Strange behaviour."

5. Now, let me turn briefly to China, which I have noted is the world's second largest economy behind the United States. In the short-term, China faces serious challenges. The official goal of 7% growth looks ambitious, the IMF forecasts 6.8% and many economists are more pessimistic.

China is risking serious financial bubbles as it fails to curb the high propensity for debt on the part of municipalities, provincial governments and state owned enterprises. To alleviate this problem the government is seeking to convert municipal debt into longer-term bonds and we have to see just how this develops. Then, the property sector is another area where a bubble exists and where we need to be concerned. And, yet another area that is disturbing is the emergence of a possible stock market bubble.

The core point is that the government has a very difficult balancing act between ensuring fiscal prudence and a sound financial system on the one hand, while securing substantial short-term real growth on the other hand.

The economic prospects for China in the medium-term depend on the success it enjoys in moving from an export dominated economy, to one where consumer spending plays the leading role. Major financial reforms, such as the lifting of caps on interest rates, the introduction of deposit insurance and the moves towards the convertibility of the RMB are important in this regard – I see these reforms proceeding ahead. These reforms also have very important roles to play as China moves rapidly to become a more prominent player in international finance – I will address this point shortly.

6. But first, permit me to talk very briefly about the three other BRIC countries – Russia, Brazil and India.

Russia has remained far too dependent on its oil and gas industries. The decline in global oil prices has hit the Russian economy very hard. The economy is in recession. Perhaps, as a distraction, this has led Mr. Putin into bolder foreign dangerous adventures.

Sanctions on Russia have also hurt and a high price is being paid in lost inward foreign investment. However, the economy is modestly boosted by recent oil price rises. Moreover, there is a widespread sense that European governments and the U.S. want better relations with Russia. This may lead the Europeans in particular to seek to soften the sanctions in due course.

Nevertheless, so long as Russia seeks confrontation with the West, so long will its economy face intense pressures. Increased economic and political ties with China will not materially relieve these pressures any time soon.

Brazil is the country with enormous economic potential that too often has risked its economy in the name of unsound governance. Brazil is in recession and unemployment at 6.4% is the highest seen in four years, while inflation is running at 8%. A major challenge is to unwind the country's overly stimulative multiyear fiscal program. The man to do this is the highly respected new Minister of Finance Joaquim Levy, who is University of Chicago trained.

But matters are complicated by the scandal surrounding Petrobras and associated scandals, which have done enormous damage to the power and influence of President Dilma Roussef who won reelection only last year with the narrowest of margins. Further damage may well result from the latest news about corruption in world soccer, where those charged include the former head of Brazil's national soccer association, (Jose Maria Marin), while the current head (Marco Polo Del Nero), who was not arrested, swiftly left Switzerland late last week before key FIFA meetings were held.

And, like other emerging market economies, there are also concerns when we look at Brazil about the impact that rising U.S. interest rates may have, drawing cash from these countries into dollar assets.

Then, there is India, heading for 7.5% growth – which will be the highest among advanced and emerging market economies. The first time in recent history that Indian growth will be greater than Chinese growth. The government of Narenda Modi is one year old. He is a bold leader, calling for many innovations to modernize the economy, to use technology in many sectors of government, to enable entrepreneurs to enjoy greater freedom from a bureaucracy that has a penchant for over-regulation. Then, Raghura Rajan, the outstanding central bank governor, is pressing ahead to lower interest rates and to open up the banking and financial sector.

However, the government continues to be totally dominated by the personality of Modi and unless he shares more power, builds a cabinet team that can lead on many fronts, there is a risk that the early gains will evaporate. India has enormous potential – it needs to have the leadership that can harness its many strengths.

7. Now let me turn to my penultimate point of international cooperation and to China in particular. One crucial issue facing China, which will impact its political and economic relations with key neighbors relates to the tensions in the South China Sea. It is certainly in China's interest to find paths to better relations with countries like the Philippines, Vietnam, Taiwan, Malaysia, and Brunei. Moreover, tensions in the North Pacific between China and Japan, the world's third largest economy, need to be resolved.

Turning to multilateral institutions, where China, and India as well, have clear desires to play larger roles, we first need to acknowledge the failure of our Administration in Washington and the U.S. Congress to provide China and India with greater influence in the IMF. Agreements on raising their so-called quotas in the IMF were reached internationally, yet the U.S. has failed to implement its part. **A further failure now by our government relates to the decision not to join the Chinese led Asia Infrastructure and Investment Bank (AIIB). Almost all of our allies have announced support for the AIIB.**

If our concerns about the AIB relate to its governance, then we should join the increasing number of other countries and become a member so that we influence its course from the inside. We should not stand outside.

The world of international institutions is changing fast as China and India, in particular, continue to move towards increasingly important positions in the world economy. The U.S. must learn to participate with them, not seek to dominate or, if it cannot immediately get its way, then stand aloof. The AIIB case underscores this point – we will join eventually, but good politics says we should join now.

8. My final point is trade. We need to recognize that at economic and political levels, efforts are being made to strengthen relations between Russia and China, while we are struggling to forge vital agreements across both the Pacific and the Atlantic.

Approval of the Trans-Pacific Partnership (TPP) is essential for the United States position in Asia. We need to continue to work to ensure that global trade and investment is promoted. The alternative is protectionism, which is dangerous. The U.S. Administration and the U.S. Congress are placing the global trading system at risk by failing to make the strong case to the American people and failing to lead.

There also needs to be new impetus on the TransAtlantic Trade and Investment Partnership (T-TIP), which is no less important for the health of the global trading system and global economy.

Thank you.