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Critical Global Economic and Financial Challenges

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Address by

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It is pleasure being with you today.

The stock markets are at, or close to, all-time highs and this may be an expression of optimism about the future. The reality, unfortunately, is that economic fundamentals are a matter of concern and currently appear largely unlinked to the rapid appreciations we have seen across the world in the values of investment assets.

So today, I want to first discuss the global economic situation in the world's major economies of the United States, China, Japan and the Eurozone. Then, I would like us to consider the robust search for yield that is driving up asset values and why, I believe, we should be concerned about reputational risk and culture in many financial institutions.

The world economy confronts many uncertainties. For example, we are seeing sluggish growth in world trade; increasingly volatile financial markets; slow growth in the U.S. economy; concerns about the financial sector in China; continuing stagnation in Japan; as well as in the Eurozone, where we also see persistently high rates of unemployment, accompanied by rising deflationary worries.

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.

Our leaders are engulfed in geo-political issues of major concern, from Ukraine to ISIS in the Middle East, while legislatures have been failing to promote fiscal and structural reform strategies in many countries that are essential for sustainable growth.

The United States

The United States remains the most powerful economy in the world and the logical place to start our discussion on the outlook for growth. Despite a great deal of political posturing on all sides, some of the most fundamental challenges to the sustained growth of our economy have not been seriously addressed in Washington.

I refer of course to 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, our children 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.

In the shorter-term, with Congress unable to do much, all eyes are turned on the Federal Reserve Board. The outlook for the U.S. economy is far from certain, although I think it likely that it could grow by 2.5% to 3% this year. The Fed will be watching a series of indicators, from the jobless numbers to inflation to growth, in determining its policies. 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. But, major uncertainty remains about the prospective course of U.S. interest rates and how the Fed will manage this.

Managing this process will test the Fed and its new Chair. Central bank coordination and clear communication across the world will be vital to avoid excessive financial market volatility, especially at a time of exceptionally high levels of liquidity that are fueling sometimes imprudent behavior in the markets as investors reach for yield.

This is especially the case as just as the Fed starts to move towards tightening monetary policy and perhaps the Bank of England will as well, while the European Central Bank (the ECB) is on a course now to ease further and Japan will continue to pursue an easy money policy for quite some time to come and China is also in the process of increasing liquidity in the state owned banking system to raise growth.

The key point is that divergent paths of monetary policy will open opportunities for arbitrage, for highly volatile short-term capital flows across national borders as investors search for yield. This could dampen confidence and the prospects for economic growth.

A critical role for Janet Yellen now relates to leadership, not only at home, but also across the world. We need to see greater coordination among central banks so that markets are better prepared and confidence is raised, I am talking about concrete measures:

First, the leaders of the major central banks meet regularly at the Bank of International Settlements in Basel. They need to use these meetings to discuss the increasing divergence in policies and the impact these risks for markets and economies.

Second, they could signal as a result of their deliberations that they – notably the major central banks – are willing to provide swap lines to some of the key central banks of emerging markets, especially those whose policies are sound and who could be subjected to damaging capital outflows.

Third, the International Monetary Fund has credit facilities that can be drawn upon by countries without additional conditonalities that may need them and that are pursuing sound economic policies. Countries that announce that they are using these IMF lines of credit signal to the markets that they are acting to strengthen their reserves.

Fourth and very importantly, the leading central banks and here the Fed again is crucial, need to find better ways to communicate clearly and in a timely manner to the public and to the financial markets.

On the positive side, the U.S. is going through an oil and gas revolution thanks to the use of hydraulic fracturing also known as "fracking". This will be, going forward, a major stimulus to the manufacturing sector and will make the country more competitive with Europe and even China. It is

expected that by the end of 2015, the US will be probably be the world's leading producer of oil and gas, surpassing Saudi Arabia and Russia.

If the challenges of fiscal and monetary policies can be met by strong leadership in our country, then the new energy reality that is emerging could enable the U.S. to enter a new era of prosperity.

China's Important Changes

Permit me now to turn to China, the world's second largest economy. I have been to China more than 70 times over the last two decades. On each visit I gain deeper insights into many aspects of this fascinating nation.

We are seeing the most far-reaching change in Chinese economic policies since former leader Deng Xiaoping made his famous 1992 Shenzhen speech. Then, he took his "modernization" program further by stressing the urgent need for the economy to strengthen investment and become far more export-oriented. Now, China's leaders are striving to put in place a new economic model where domestic consumption is at center stage and where there will be a substantial opening up of the economic system.

The years of double-digit economic growth in China are over. The challenge before China's leaders is to move to the new model and attain at least 7% annual growth.

The government has set plans that will see a major strengthening of market forces in China; the gradual transformation of state owned enterprises into far more market-based and better managed institutions; and, the encouragement of all manner of programs to see that Chinese save less and spend more, so that domestic consumption becomes a key driver of growth.

We will also see far-reaching financial innovations, from the freeing up of interest rates, to possibly the introduction of deposit insurance. I also would not be surprised if there will be full RMB convertibility in five to seven years.

The government has announced that it plans to establish a free trade zone in Shanghai, which will serve as an important laboratory for testing financial sector reforms.

However, China's authorities must confront a number of serious problems in the financial sector: excessive borrowing by municipal and provincial governments and state-owned enterprises; the risks of rapid growth of the shadow banking sector; and, rising levels of non-performing loans at the major commercial banks and also how to deal with a major property bubble.

The government must act to ensure that the banks do not get back into the crisis situation seen a little over a decade ago, when a host of costly and complex special measures had to be taken, such as having the Peoples' Bank of China, its Central Bank recapitalize the state owned banks and establish asset management companies to take over the problem loans.

China's authorities need to find ways to communicate clear timetables for the implementation of their economic and financial reform policies.

As I have noted, the challenge is to pursue the reforms while keeping annual growth at or above 7%. Right now it is unclear whether this level of growth will be reached this year. It may do so, but only with the government slowing the pace of some financial reforms, slowing efforts to curb actual and potential excesses in the financial sector, and indeed providing new paths for public authorities to raise cash in the markets which can spur growth.

Moreover, in addition to these substantial economic and financial challenges, the authorities need to find constructive approaches to dealing with over-arching problems of great concern to the people of China, notably addressing the intense pollution and environmental degradation that has become widespread; and, importantly, building public trust in government by curbing corruption.

We also need to be concerned about the rising tensions, between China and Japan as well as actions by China in the South China Sea.

Japan's "Abenomics"

Now, turning to Japan. After nearly two decades of stagnation, Japan's leaders have set out on a new course, but it has still not achieved the results that the government is looking for.

The strategy that Prime Minister Abe is pursuing – Abenomincs - consists of "three arrows:" aggressive monetary easing, fiscal stimulus, and structural reform. Given the country's debt to GDP ratio of approaching 240% according to IMF data, the government felt bound in April to raise the consumption tax from 5% to 8%. It is still not clear how deep the impact on growth will be of this measure.

What is clear, is that so far action on the key arrow of structural reform and deregulation has been slow. This it will be absolutely vital to the success of the program as a whole. Prime Minister Abe recognizes that monetary expansion and a weaker currency alone will not turn around the Japanese economy.

Prime Minister Abe's recent major cabinet reshuffle is designed in part to emphasize the importance he attaches to structural reform. He needs to turn around an enormously rigid economy, where the role of the state in finance has been overly large, where the roles of women in business and employment have been far too small, and where innovation has not been sufficiently supported.

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

Now, let me turn to the 18-member country euro-zone: here the problems are complicated, solutions remain elusive, and the lessons from my book have largely been ignored at great cost.

The European authorities and many economists have been suggesting for some time that the euro-zone's outlook has been improving. The facts, however, are discouraging.

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; France has now had two consecutive quarters of zero growth; while Italy is now in recession with negative 0.2% in the last quarter after negative 0.1% in the first quarter.

Germany, the power-house of the euro-zone, dominates policy across the Eurozone and has preached fiscal austerity, while placing far too little emphasis on promoting growth. The Italian and French governments are gradually challenging this core policy, as these economies face minimal growth and enormous unemployment.

In recent months we have seen the ECB act. In early June, it announced interest rate cuts alongside plans to directly add liquidity. It stated that it would be conducting a series of targeted longer-term refinancing operations (TLTROs) with a planned initial volume of around Euro400 billion.

But growth has been unsatisfactory and concern about deflation has been rising, with the latest inflation rate across the zone at around 0.4%. New measures were called for.

On September 4, the ECB announced that it is lowering the interest rate on the main refinancing operations of the Eurosystem by 10 basis points to 0.05% and the rate on the marginal lending facility by 10 basis points to 0.30%. The rate on the deposit facility was lowered by 10 basis points to negative 0.20%. In addition, the ECB decided to start purchasing a broad portfolio asset-backed securities (ABSs) in the markets to strengthen credit flows to the economy.

The ECB said it will also purchase a broad portfolio of euro-denominated covered bonds issued by financial institutions under a new covered bond purchase program (CBPP3). The details on these interventions will be announced on October 2.

All of these measures are designed to both counter the deflationary trend, while boosting job creation. Unemployment is an enormous problem today in the region.

The average rate is 11.5% and more than 19 million people are officially out of work. In some countries the unemployment rate is well into double digits and double even that when it comes to the unemployment of young people. For many young people the prospects are for a lost decade of economic activity.

The high jobless rates in the euro-zone do not only have economic and social consequences, but political ones as well. They undermine the ability of these countries to restore public respect for established political parties and provide leaders with the mandates needed to introduce vital structural reforms. A concerted focus on growth at the national and the EU levels, as well as by the ECB is vital.

Further, Mario Draghi knows that the banking system in Europe NEEDS to become an engine of growth and many of the recent measures aim to boost bank lending, notably to small- and medium-sized enterprises. The banks account for fully 75% of the European capital markets and lending are absolutely key. I have long argued that the Eurozone needs a comprehensive and efficient banking union.

Political arguments in Brussels, however, have resulted in weak compromises on many aspects of what should be a strong banking union. The ECB has at last finally won supervisory authority of a large part of the banking system. Indeed, the forthcoming stress tests are vital to create a starting point for strengthening the ability of banks to lend and generate the finance needed for job creation.

The Search for Yield

Against this background permit me to turn to my second topic, concerns about the search for yield in financial markets.

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.

Last month I published another comment article in *The Financial Times*, because once more I believe we need to be most 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.

Culture and Risk Behavior

A concern relates to the fact that the banking authorities since the financial crisis have been so focused on banking data, such as capital and liquidity ratios, that they have not paid sufficient attention to risk behavior. This is less subject to metrics and often involves sophisticated subjective judgments.

More fundamentally, colleagues in the Group of 30 - a forum of international financial leaders from both the public and private sectors - have for some time been seeking to promote discussion about core issues of culture in finance, especially those that relate to reputational risk and behavior.

The risk management component of culture always poses challenges to financial institutions – there is a lot of complexity around the interplay between the four major types of risk: credit risk, market risk, operational risk and reputational risk. If managers make serious errors in any of the first three areas, then the reputational consequences are always serious.

The failings in risk management, which are often related to the reach for yield, which were a hallmark of the run-up to the 2008-09 financial crisis, did enormous damage to the reputations of nearly all major financial institutions – not just the banks, but also the supervisory agencies themselves.

Gradually, many bankers, regulators and supervisors have reached the conclusion that there needs to be greater focus on the core issues of banking culture. These perceptions have emerged clearly over the last nine months in a series of discussions between bankers and officials around a report published by the Group of 30 in October 2013, A New Paradigm: Financial Institutions Boards and Supervisors.

Members of the Financial Stability Board encouraged the development of this report and they have recently supported the idea that the G30 consider writing a follow-up study on banking culture, conduct and reputation. I would welcome your views on this important topic.

The New Paradigm report underscored that considering culture together with governance and business strategy is an essential part of forward-looking supervision. Issues of culture, and particularly risk culture, are "soft" and correspondingly often difficult for managements and supervisors to deal with.

An important approach would see regular exchanges of views, where supervisors could confidentially share knowledge they have gained from system-wide experiences, while obtaining a deeper understanding of the unique cultural aspects that every bank has.

Managers and boards in a number of banks and other financial institutions need to place more emphasis on promoting integrity and trust as the guiding principles of corporate culture. The more effective they can be in attaining this goal the more they will strengthen public and shareholder confidence and improve relationships with regulators and supervisors.

Thank you.